87-303 (1)

No. ____

FILED
AUG 21 1987
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,
Petitioners,

—v.—

HANNAH FINKEL,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Question Presented

Is the reliance element of a claim under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 satisfied by a plaintiff's allegation that he relied solely upon "the integrity of the marketplace", and not upon the allegedly misleading statements?

PARTIES TO THE PROCEEDING

The caption of the case in this Court contains the names of all the parties to the proceedings in the court below.

Petitioner Docutel/Olivetti Corporation is a wholly-owned subsidiary of Ing. C. Olivetti & C., S.p.A. In accordance with Supreme Court Rule 28.1, a list of petitioners' parents, subsidiaries and affiliates appears in the Appendix. (33a-35a).

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DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

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—v.—

HANNAH FINKEL,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners are defendants in this action: Docutel/Olivetti Corporation ("Docutel"), Ing. C. Olivetti & C., S.p.A. ("Olivetti"), and some, but not all, of Docutel's officers and directors during the time period of the complaint.[1] They respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit that affirmed in part and reversed in part an Order of the United States District Court for the Northern District of Texas. The District Court had dismissed the complaint for

1 Petitioners B.J. Meredith and Emmet R. DeMoss were the chairman and chief executive officer and the executive vice president and chief financial officer of Docutel during at least part of fiscal 1983. Petitioners Carlo DeBenedetti and Simone Fubini were the chief executive officer and chief operating officer of Olivetti. Petitioner Elserino M. Piol was a director of Olivetti. Mssrs. DeBenedetti, Fubini and Piol were members of the Docutel board at some point during fiscal 1983.

failure to state a claim under Securities Exchange Act § 10(b) and Securities and Exchange Commission Rule 10b-5, because plaintiff failed to plead that she relied upon, or even knew about, the alleged misstatements about the value of Docutel's inventory that were the sole basis of her complaint.

Opinions Below

The Opinion of the Court of Appeals is reported at 817 F.2d 356 (5th Cir. 1987). It is set forth in the Appendix (1a-17a). The Order of the District Court is unofficially reported at [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,944 (N.D. Tex. 1986). It is set forth in the Appendix (18a-19a).

Jurisdiction

The judgment of the Court of Appeals was entered on May 27, 1987 (20a-21a). This Court has jurisdiction to review that judgment by writ of certiorari under 28 U.S.C. §§ 1254(1), 2101(c).

Statute and Rules Involved

The statute and rules involved in this proceeding are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5. They are set forth in the Appendix (22a-23a).

STATEMENT OF THE CASE

Docutel was formed in 1967 to make automatic teller machines (ATMs). In 1982, Docutel expanded its product line to include typewriters, personal computers, and related equipment by merging with Olivetti Corporation of America, Olivetti's United States subsidiary. After the merger, an Olivetti subsidiary owned 46% of Docutel's stock.[2] As of October 1, 1983, Docutel's stock was held by approximately 3200 public shareholders. The stock was traded in the "Over-The-Counter" market.

On December 5, 1983, Mrs. Finkel purchased 300 shares of Docutel at $14 5/8 per share, for a total cost of $4,474.75. On February 16, 1984 Docutel announced that, based on preliminary results, it anticipated a net loss of about $14 million for its fiscal 1983. The last reported price for Docutel shares on February 15 was $11.50 per share, which declined to $10.00 per share by the close of February 17, 1984.[3]

On April 12, 1984 Mrs. Finkel filed a complaint (24a-32a) alleging violations of Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and Securities and Exchange Commission ("SEC") Rule 10b-5. The suit was brought on behalf of a purported class of anyone who purchased Docutel stock between April 29, 1983 and February 16, 1984.

The complaint rests solely on statements about Docutel's financials in the Wall Street Journal, and statements in Docutel's form 10-Q reports filed with the SEC for the quarters ended March 31, 1983, June 30, 1983, and September 30, 1983. The complaint alleges that Docutel knowingly or recklessly "overstated" the value of Docutel's inventory, and thus "over-

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2 In August 1985 Docutel was merged into a wholly-owned subsidiary of Olivetti. Its name has been changed to Olivetti U.S.A., Inc.

3 On April 2, 1984 Docutel announced that the reported loss would "significantly wider", and Docutel's form 10-K for 1983 reported a loss of $18,263,000, including $10,900,000 in ATM and office product inventory write-downs. The last reported price for Docutel stock on April 2 was $7.62 per share, which was the same price as the closing price on April 3, 1984.

stated" Docutel's net profits and "understated" net losses and cost of revenues. (30a-31a).

There is no allegation that Mrs. Finkel read, saw, or even knew about any of the alleged misrepresentations about Docutel's inventory or earnings before making her decision to buy. There is no allegation that Mrs. Finkel relied upon any of the alleged misrepresentations in making that decision. Indeed, there is no indication that Mrs. Finkel knew anything whatever about Docutel before deciding to buy. The complaint states only that she relied upon the "integrity of the market" for Docutel stock. (31a).

Petitioners moved to dismiss the complaint under Fed. R. Civ. P. 12(b)(6) for failure to plead individual reliance on the alleged misleading statements, and under Fed. R. Civ. P. 9(b) for failure to plead fraud with particularity. *See* 817 F.2d at 358; (4a). The district court deferred discovery and class certification pending a decision on the motion. *Id.*; (4a). On August 20, 1986 District Judge Robert B. Maloney dismissed the complaint for failure to plead individual reliance. (18a-19a).

Mrs. Finkel filed a notice of appeal on September 17, 1986. In an opinion dated May 27, 1987 the Fifth Circuit affirmed in part and reversed in part. The Court held that reliance on alleged misstatements is required under SEC Rule 10b-5(2) and affirmed the dismissal of the claims under Rule 10-5(2). The Fifth Circuit noted that its holding dismissing the Rule 10b-5(2) claims was in direct conflict with those of other Circuits that permitted "fraud on the market" reliance for Rule 10b-5(2) claims. 817 F.2d at 362-63 & n.17; (12a-13a).

The Court, however, went on to hold that reliance is unnecessary under Rule 10b-5(1) and Rule 10b-5(3) for a "fraud on the market" claim alleging non-disclosures. 817 F.2d at 362-63; (12a-13a). The court found that the complaint, although it contained only allegations of affirmative misstatements of the value of Docutel's inventory, could nevertheless be construed

as a non-disclosure case falling within Rules 10b-5(1) and (3). 817 F.2d at 363; (14a). The Court therefore reversed the district court and reinstated the complaint for claims under Rules 10b-5(1) and (3).

REASONS FOR GRANTING THE WRIT

Is individual reliance an antiquated relic of earlier, less sophisticated times? Should it be abolished in light of modern theories? The Fifth Circuit's answer: yes. But in rejecting individual reliance, the court below was not applying new theories or learning. By 1934 Congress already knew that a fraud may affect the market price of an actively traded stock. The court below simply disagreed with Congress's decision, in drafting the liability provisions of the 1934 Act, to require both market impact *and* individual reliance in a fraud case.

Congress recognized in § 18 of the 1934 Act that a fraud concerning an actively traded security may have two, sometimes unrelated, effects: (1) it may induce some people to buy the securities, and (2) it may affect the market price. Congress determined that both must be proved before recovery would be permitted.[4] The so-called "fraud on the market" theory is nothing less than the judicial assertion that Congress erred in its judgment, and that a plaintiff should only have to prove that the market price was affected, without any need to show that the fraud caused the purchase or sale.

The Fifth Circuit's decision thus is not the application of law to a changing environment. It is judicial policy-making, in which a court effectively repealed any requirement that a

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4 A detailed, but concise summary of the references to the reliance requirement in the legislative history of Section 18(a) of the Securities Exchange Act, 15 U.S.C 78r(a), appears in Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements In Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 464 n.191 (1984).

misstatement cause a purchase or sale, because that court disagrees with a congressional judgment.

Nor is this a single aberration that could be corrected by allowing the lower courts to resolve the issue. The Fifth Circuit is only one of a number of Circuit Courts of Appeals that have used some form of fraud on the market theory to effectively abolish the reliance requirement in cases involving actively traded securities. Driven by a desire to permit broad based class actions,[5] those courts have—in order to facilitate a procedural device—adopted a policy-making role and decided that individual reliance is unnecessary.

This Court has already recognized the need for review of fraud on the market theory in the class action context. *See Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (Feb. 23, 1987) (No. 86-279). The present case, however, involves the use of the theory to eliminate one of the traditional elements of the substantive 10b-5 action itself. For this, and other reasons discussed below, this case represents a superior vehicle for reviewing fraud on the market theory and should be reviewed either as a companion case to *Basic Inc.*, or alone.

The clear intent of Congress in passing the 1934 Act was to limit recovery to people who actually tried to make an informed decision based upon facts that Congress mandated be

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5 These decisions are motivated by an apparent concern that if reliance is an individual issue, courts will be unable to certify class actions in Rule 10b-5 cases. *See, e.g., Finkel, supra*, 817 F.2d at 360 n.10; (9a). ("The [fraud on the market] theory has special and obvious appeal in class actions because the need to prove a personalized reliance by each class member is avoided.") This concern is unfounded. The class action device is sufficiently flexible to work with the traditional elements of Rule 10b-5. *See* Part III, *infra*. It is a clear case of the "tail wagging the dog" for courts to eliminate reliance from Rule 10b-5 in order to make it easier to certify a class action.

disclosed.[6] That clear intent should be honored in the judicially implied cause of action under § 10(b). Because the lower courts have not done so, this Court should grant certiorari and reverse.

I. In Adopting the "Fraud on the Market" Theory, The Fifth Circuit Decided An Important Question of Federal Law That Has Not Been Decided By This Court, And Decided It In Conflict With The Clear Intent Of Congress

Section 10(b) bars *deception* in connection with the purchase or sale of securities. Congress knew the well-defined elements of a claim for deceit when it adopted § 10(b). *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977). Since it was first implied, in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), the cause of action under Rule 10b-5 has incorporated the basic elements of the common law deceit action. Thus, a 10b-5 plaintiff alleging deception is required to plead and prove:

1. A misstatement or omission
2. Of a material fact
3. Made with scienter
4. On which the plaintiff relied (sometimes called "transaction causation")
5. In connection with the purchase or sale of securities
6. That caused the plaintiff damage (sometimes called "loss causation")

Cf. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974) (distinguishing between "transaction causation" and "loss causation"), *cert. denied*, 421 U.S. 976 (1975).

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6 The Senate Report commented concerning the express civil remedies in the 1934 Act that, "the burden is on the plaintiff to show the violation or the fact that was false or misleading and that he relied thereon to his damage." S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934), *quoted in, Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

The fundamental logical flaw of the fraud on the market theory is that it permits a plaintiff to meet the requirement of pleading transaction causation by repeating, instead, allegations of loss causation. That is, by simply stating that the market price was affected by the misstatements, the plaintiff is excused from having to prove that his or her decision to buy was affected by that misstatement. Eliminating the reliance requirement is directly contrary to this Court's decisions, which have consistently refused to eliminate basic elements of the judicially implied cause of action for deceit under § 10(b).

In *Santa Fe, supra*, this Court insisted on proof of deception. In *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), this Court held that objective materiality of the misrepresentation was necessary. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), this Court enforced the requirement that a plaintiff have actually purchased or sold a security to state a claim. And in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that *scienter* was required for any claim under § 10(b), rejecting attempts to predicate Rule 10b-5 liability on negligence.

This Court has not addressed the reliance requirement except for its decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). *Affiliated Ute* applied the common law principle that in a face-to-face relationship where there is a duty to speak, silence about a material fact can be as deceiving as an affirmative misstatement. This Court has never addressed the validity of the so-called "fraud on the market theory".

A. The Fraud On The Market Theory Constitutes The Judicial Repeal of the Individual Reliance Requirement For Rule 10b-5 Claims Involving Actively Traded Securities

Although couched in modern economic terms, the fraud on the market theory is simply the repetition of an old argument, already rejected by Congress: once it is proven that a fraud

caused a security's market price to be altered, it should not be necessary for the plaintiff to prove that the fraud had anything to do with the decision to buy or sell the security. Fraud on the market is not a new theory. It is the judicial repeal of the reliance requirement.

Under the theory, a plaintiff can choose a stock by throwing a dart at a newspaper, or by consulting an astrological chart, and still recover. There is no need to show that he or she relied on or even knew of the alleged deceptive statements or conduct. The plaintiff need only allege that "the market" was defrauded, causing an artificial increase or decrease in a security's market price.[7]

If the plaintiff purchased or sold a security at the fraud-affected price, then he or she is damaged (*i.e.* there is loss causation). Under fraud on the market theory, that is enough. The plaintiff can recover even if the deception had nothing whatever to do with the decision to buy or sell the security. Thus, the plaintiff can recover in the complete absence of any proof of transaction causation, *i.e. without* the reliance Con-

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7 The fraud on the market theory rests on a simple version of the "efficient market hypothesis" (EMH). The EMH holds that large and developed securities markets digest all available information about a company and immediately reflect that information in a market price. If material misstatements are made about a company, and the company's securities are traded in efficient markets, the market price of the securities will, by hypothesis, be skewed. *See* Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 3-5 (1982). In its simple form, EMH is nothing more than the statement, already codified by Congress in the civil damages provisions of the 1933 and 1934 Acts, that a misstatement can cause the market price of a security to be inflated or depressed.

The EMH, however, has an additional element. It states that it is impossible for anyone to learn more about a stock than the market already knows. Thus, research about a stock is pointless and futile. *See* Fischel, 38 Bus. Law. at 4-5, 13. It is this controversial and oft-challenged part of the EMH that is used to support the abolition of reliance in the "fraud on the market" theory. Since individual knowledge is futile, any legal requirement that encourages such actions is pointless and unnecessary. Thus, individual reliance is unnecessary and should be abolished.

gress decided was necessary to link the plaintiff's investment decision to the defendant's conduct. *Compare* 78 Cong. Rec. 7701 & 8039 (1934) (Remarks of Rep. Rayburn on the importance of the reliance requirement).

B. The "Rebuttable" Presumption of Reliance Is In Fact Irrebuttable; It is Simply A Mask for the Removal of Reliance

Courts that have adopted the fraud on the market theory purport to retain individual reliance by "presuming" that the plaintiff "relied" on the integrity of the marketplace, *i.e.*, that he or she trusted that the price paid or received was fairly set and not affected by a fraud. *See, e.g.*, *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). This reliance requirement is meaningless. Everyone who buys or sells securities in any transaction, whether face to face or on the open market, relies on the assumption that the price is free from fraud.

This "presumption of reliance" has nothing to do with whether the defendant's conduct *induced* the plaintiff to purchase or sell a security ("transaction causation"). Indeed, since a plaintiff may under the theory choose a stock by throwing a dart, consulting a Tarot card reader, or using any other random method, the fraud is—by definition—immaterial to the investment decision.

The illusory nature of the reliance requirement under the fraud on the market theory is further highlighted by the manner in which the presumption of reliance may be rebutted. Rather than rebutting by proving that the plaintiff's decision to purchase or sell was unrelated to defendant's statement or conduct (*i.e.*, there was no transaction causation), the plaintiff must admit under oath that he or she would have been willing to buy or sell at a fraud-distorted price (*i.e.*, there was no loss causation). *See Finkel, supra*, 817 F.2d at 364; (17a). *Peil v. Speiser*, 806 F.2d 1154, 1163 (3d Cir. 1986).

In order to rebut this "presumption", the plaintiff would have to state, under oath: "I do not care if I am defrauded. I am perfectly willing to pay a fraudulently inflated price for this stock. I would have bought it even if I had been told that I was being cheated." The odds against such testimony ever being given make the presumption effectively irrebuttable.

The fraud on the market theory thus completely severs a plaintiff's decision to buy or sell from the defendant's conduct. The plaintiff may have ignored all congressionally mandated or other public disclosure about an issuer, may have picked his or her stocks at random, and is still permitted to recover. This result is antithetical to congressional intent as expressed in the Exchange Act, and to the wisdom of courts that have imposed the reliance requirement in common law actions for deceit.

C. Elimination of Reliance Overrides the Clear Intent Of Congress

In enacting the 1933 and 1934 Acts, Congress intended to insure that all investors would have access to full and accurate corporate disclosure. *See Hochfelder, supra*, 425 U.S at 195. Equally important was full disclosure of information necessary to promote shareholder control and shareholder democracy. *See TSC Indus., supra*, 426 U.S. at 448. The underlying philosophy of the securities laws is that investors will read or learn of this material in making their investment decisions. *See* Fischel, *supra*, 38 Bus. Law. at 2-3.

The reliance requirement of the Acts' express remedies, such as § 18, and of the implied remedy under § 10(b), play a key role in promoting this philosophy "by precluding recovery to a plaintiff who has made an investment decision by his own lights and without reference to the information promulgated under the disclosure requirements of the federal securities laws." *Shores v. Sklar*, 647 F.2d 462, 483 (5th Cir. 1981) (en banc) (Randall, J., dissenting), *cert. denied*, 459 U.S. 1102 (1983). Indeed, in § 18(a) Congress explicitly rejected the

argument that all a plaintiff need show is a market price affected by a fraud. Instead, Congress required a plaintiff to prove *both* that he or she relied on the deception in making a purchase or sale *and* that the market price of the security was affected by the deception. *See* 15 U.S.C. § 78r(a).

This reliance requirement was the result of a legislative compromise between those legislators who favored broad remedies and those legislators who were concerned about the impact of numerous unfounded lawsuits. *See* Black, *Fraud on the Market: A Criticism of Dispensing With Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 464 n.191 (1984) (citing to and quoting from congressional reports, debates and hearings on § 18(a)).

The reliance requirement in implied claims under § 10(b) carries out this clear congressional intent. *See Herpich v. Wallace*, 430 F.2d 792, 804-05 & n.12 (5th Cir. 1970). Its elimination would effectively repeal that intent. By pursuing claims under a fraud on the market theory, a plaintiff can avoid the reliance required by § 18(a). Because the other elements of a § 18(a) claim are at least as burdensome as those of Rule 10b-5, the result is the effective repeal of § 18(a). *Cf. Herman & MacLean v. Huddleston*, 459 U.S. 375, 382-83 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208-210 (1976); *but cf. Chemetron Corp. v. Business Funds, Inc.*, 718 F.2d 725, 727-28 (5th Cir. 1983); *Ross v. A.H. Robbins, Co.*, 607 F.2d 545, 555-56 (2d Cir. 1979), *cert. denied*, 446 U.S. 949 (1980).

This Court need only consider how many times a plaintiff sues under § 18(a) to understand how thoroughly that explicit remedy has been displaced by the judicially implied remedy under § 10(b). To further undercut congressional intent by removing the reliance requirement from this judicially implied cause of action would be nothing less than a judicial decision that Congress was wrong in 1934; that the 1934 Act should be rewritten in light of current judicial views.

D. The Fraud on the Market Theory Rests Upon the Unproven Assumption That No One Can Ever Learn More Than The Market, and That Any Doctrine, Such As Reliance, That Encourages Investors to Become Informed Is Inefficient and Unnecessary

The fraud on the market theory's rejection of reliance rests on the unproven assumption that the market is so efficient that no one can possibly "beat" it through investigation or education. Since all individual knowledge is futile, it is pointless to require individual reliance on such knowledge. *See* Fischel, *supra*, 38 Bus. Law. at 3-5, 8. A reliance requirement thus only encourages investors to waste their time on pointless investigation.

The fraud on the market theory rejects the disclosure philosophy of the securities laws as mistaken. It rejects the reliance requirement as an anachronism. As the *Finkel* panel explained:

> [The theory] rejects the traditional notion of the investor who acts after carefully examining all available information. It says investors need not, and do not, act that way in an open market transaction, because they have a right to presume the market's integrity.

817 F.2d at 360 (footnote omitted); (8a). It is thus "inefficient" under this theory for an investor to bother reading a disclosure statement.

This second element of the EMH, the alleged futility of individual effort, is controversial and under attack. *See* Gordon and Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761, 765 n.8 (1985) (citing sources). If the disclosure philosophy of the 1933 and 1934 Acts should be abandoned in favor of codifying a dubious theory such as the Efficient Market Hypothesis, that decision is for Congress and not the courts. *See Shores*, *supra*, 647 F.2d at 483 (Randall, J. dissenting); *Fausett v. American Resources Management Corp.*, 542 F. Supp. 1234, 1238 (D. Utah 1982).

Proponents of the fraud on the market theory argue that limiting Rule 10b-5 recovery to plaintiffs who can show reliance will limit recoveries and remove the deterrent effect of private actions. *See Blackie v. Barrack*, 524 F.2d 891, 907-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). In *Blue Chip Stamps*, this Court considered and rejected the same policy arguments. This Court stated that the purchaser/seller rule had been widely criticized as "unreasonably prevent[ing] some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5." 421 U.S. at 738. But without the rule, there would be an enormous potential for "strike suits", abuses of the "liberal discovery provisions of the Federal Rules of Civil Procedure", and complex litigation that would hinge upon uncorroborated evidence—effectively eliminating motions to dismiss and motions for summary judgment. *Id.* at 741-42.

This Court concluded: "However flexibly we may construe the language of both [section 10(b) of the Exchange Act and Rule 10b-5] . . . [w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.* at 749.

The reliance requirement reflects principles developed over hundreds of years of common law. It is part of the basic legislative intent and compromise that led to the creation of statutory causes of action under the securities laws. By linking plaintiff's decision to purchase or sell to defendant's conduct, the reliance requirement expressly delimits the class of persons entitled to recover damages under the securities laws to those who have at least tried to use the information Congress mandated be disclosed.[8] Elimination of reliance transforms a

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8 A plaintiff can rely upon the disclosures in many ways: by reading them, by reading a newspaper or financial publication that reports them, or by consulting with a broker or other person about the substance of the

§ 10(b) suit from a protection against deception into a "scheme of investors' insurance." *Shores*, 647 F.2d at 469 n.5.; *List v. Fashion Park Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

II. The Decision Below Is In Direct Conflict With The Decisions of Other Circuit Courts And With Decisions Of This Court

A. Conflict Within the Circuits

The Fifth Circuit's decision reflects the confusion faced by the courts that have adopted some form of the fraud on the market theory. The theory requires the elimination of reliance as an element of a Rule 10b-5 claim. Case law, however, still requires reliance. The Fifth Circuit attempted to resolve this conflict by requiring reliance in Rule 10b-5(2) cases, while excusing it in Rule 10b-5(1) and (3) cases. This resolution, however, is in conflict with other circuit courts that have dealt with the problem by creating an effectively irrebuttable presumption of reliance for all cases.

The Fifth Circuit recognized that its decision requiring reliance for Rule 10b-5(2) claims conflicted with decisions of other Circuit Courts of Appeals:

> We hold . . . that *Shores* permits a plaintiff to assert a fraud on the market theory under 10b-5(1) and (3) but not under 10b-5(2) . . . . Other Circuits have gone even farther, and recognize the fraud on the market theory under 10b-5(2).

817 F.2d at 362-63; (12a-13a) (footnote omitted) (citing *Peil v. Speiser*, 806 F.2d 1154, 1162-63 (3d Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *Blackie v. Barrack*, 524 F.2d 891 (9th

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disclosures. Satisfying the reliance requirement thus will not be difficult for any reasonably prudent investor.

Cir. 1975), *cert. denied*, 429 U.S. 816 (1976)). Indeed, the Fifth Circuit expressly disagreed with the 11th Circuit's interpretation of *Shores v. Sklar* that permitted fraud on the market claims in Rule 10b-5(2) cases. 817 F.2d at 363 n.18; (13a).

The Fifth Circuit's decision also conflicts with the Third Circuit's decision in *Peil*, which expressly declined to draw a distinction between fraud on the market claims brought under Rule 10b-5(2) and those brought under Rules 10b-5(1) and (3). According to *Peil*, "A single misrepresentation or omission, like a more widespread scheme, may artificially inflate the price of a stock and thus defraud plaintiffs who rely on the price. . . ." 806 F.2d at 1162 (citation omitted). *Peil* thus permits someone alleging even a single misrepresentation in a disclosure document to state a claim under Rule 10b-5(2), even if the investor did not see or in any way rely on the alleged misrepresentation. *Id.* at 1163.

This conflict reflects the basic flaw of fraud on the market theory. As one commentator noted, "Some opinions have emphasized the need for a comprehensive scheme to defraud . . . to establish a fraud on the market claim. These courts are struggling to establish a special category of fraud on the market cases to separate these cases from run of the mill misrepresentation cases in which plaintiffs must establish reliance." Black, *supra*, 62 N.C. L. Rev. at 457 n.137 (1984) (citations omitted). As long as this issue remains unresolved, the elements of a claim for relief under Section 10(b) and Rule 10b-5 will vary with the Circuit in which the plaintiff brings his or her suit.

B. Conflicts With This Court's Decisions

Despite its refusal to adopt "fraud on the market theory" for Rule 10b-5(2) claims, the *Finkel* panel strained to salvage respondent's complaint. It did so by reading into the complaint a claim for non-disclosures. The court then found that this judicially pleaded claim was actionable under Rules 10b-5(1) and (3) even without a showing of reliance. 817 F.2d at 363; (14a-15a).

Characterizing this complaint as alleging a "non-disclosure" claim, however, means that any complaint can be brought under Rule 10b-5(1) or (3). The complaint alleges misstatements of the same Docutel financials in the Wall Street Journal and in three of Docutel's form 10-Q reports—and nothing else. This is a "classic" 10b-5(2) misrepresentation case. It has nothing in common with cases such as *Affiliated Ute* "involving primarily a failure to disclose."[9]

In straining to uphold the complaint, the Fifth Circuit ignored its previous opinion in *Huddleston*, which held on similar facts:

> This case, *involving alleged misstatements and omissions in a prospectus published pursuant to a public offering*, cannot properly be characterized as an omissions case of the type for which the *Affiliated Ute* presumption was fashioned. The defendants did not "stand mute" in the face of a duty to disclose as did the defendants in *Affiliated Ute*.

Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. Unit A Mar. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983) (emphasis added).

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9 *Affiliated Ute* involved a plan by defendants, bank employees, acting as fiduciaries for petitioners, American Indian stock beneficiaries, to defraud the Indians into selling their stock to non-Indian buyers at below-market prices. The defendants failed to disclose that they were making the market for the non-Indian buyers and were benefitting personally from the sales.

This Court held that the defendants could not induce the Indians to sell their stock and "stand mute" as to their financial interests in the sale. 406 U.S. at 153. The Court ruled that petitioners had stated a claim under Rule 10b-5 despite the lack of affirmative misstatements on which they could rely: "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." *Id.* Significantly, there was no question that the plaintiffs' investment decisions were directly tied to the defendants' conduct. *See id.* ("defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares . . . .").

Docutel did not "stand mute" as to its inventory. Docutel announced a value for its inventory and for its earnings. The complaint alleges only that the numbers were too high. There can be no clearer misrepresentation case. If misstatements in three publicly-filed documents may be construed as a non-disclosure case under Rules 10b-5(1) and (3), then the reliance requirement of Rule 10b-5(2) is truly a "dead letter". *See Finkel, supra*, 817 F.2d at 364 n.22 (citing discussion in *Shores*); (15a); *see also* 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 2.6(1) at 49 (1986) ("10b-5 seems to have another mysterious capacity perhaps shared by the human brain: one part can take over the function of the other.").

The Fifth Circuit's decision also implicates the federalism concerns of this Court's decision in *Santa Fe*. The Fifth Circuit found that "[t]he most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the market place. . . ." 817 F.2d at 363; (14a-15a). Apart from the complete lack of such a "claim" in the complaint, requiring Olivetti to state that it was forcing worthless inventory on Docutel, and requiring Docutel to state that it was accepting worthless inventory, runs counter to *Santa Fe*.[10] It predicates Rule 10b-5 liability on a failure to disclose alleged breaches of fiduciary duty or corporate mismanagement.

This Court held in *Santa Fe* that, absent deception, breaches of fiduciary duty are not actionable under Rule 10b-5. 430 U.S. at 473-74. If the failure to disclose a breach of fiduciary duty states a claim, then a plaintiff can negate this Court's

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10 At the time complained-of, Olivetti was not even a majority shareholder of Docutel. The Fifth Circuit's creation of a duty to disclose owed by Olivetti effectively imposes an affirmative obligation on *shareholders* to disclose their own possible breaches of fiduciary duty. Similarly, forcing Docutel to disclose it is accepting worthless inventory creates an obligation under the federal securities laws to admit corporate mismanagement. Finally, it bears repeating that the Fifth Circuit's reference to an alleged scheme to force worthless inventory on Docutel finds no support whatsoever in the complaint itself, which merely alleges that Docutel overstated the value of its inventory.

ruling in *Santa Fe* with nothing more than artful pleading. *See Bisenbach v. Guenther*, 588 F.2d 400, 402 (3d Cir. 1978) ("In effect, appellants are stating that the failure to disclose the breach of fiduciary duty is a misrepresentation sufficient to constitute a violation of the [Exchange] Act. We refuse to adopt this approach which would clearly circumvent the Supreme Court's holding in *Santa Fe*.")

III. This Court has Already Recognized That Fraud on the Market Theory Raises Important Federal Issues

On February 23, 1987 this Court granted a petition for a writ of certiorari to review the Sixth Circuit's decision in *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S.Ct. 1284 (Feb. 23, 1987) (No. 86-279). The second "Question Presented" in *Basic Inc.* is whether the Sixth Circuit erred in affirming the district court's certification of a Rule 10b-5 class action by applying the fraud on the market theory's "presumption of reliance" as a substitute for the requirement that each class member show that his decision to sell his shares was made in reliance on one of the alleged fraudulent statements. At the time of this writing, the parties in *Basic Inc.* have submitted their briefs, but the case has not yet been scheduled for oral argument.

Although *Basic Inc.* and this case involve the validity of the fraud on the market theory, there are substantive and pragmatic reasons this Court should review this case either as a companion case with *Basic Inc.* or alone.

First, the record is ideally suited for review of pure legal issues. As the Fifth Circuit stated, "[b]ecause no discovery was taken, the record is spare; it consists of only basic pleadings." 817 F.2d at 358 n.5; (4a). This is a Fed. R. Civ. P. 12(b)(6) case presenting a pure question of law: may the courts use the fraud on the market theory to eliminate individual reliance as an element of the cause of action under § 10(b) and Rule 10b-5.

Basic Inc., by contrast, raises the issue in the context of Fed. R. Civ. P. 23(b)(3). It asks whether it was an abuse of discretion for a district judge to find that common class issues predominate over individual issues in that case. One of the bases for that determination was the use by the District Court of the fraud on the market theory to eliminate any need to examine anyone's reliance on the fraud. *Basic Inc.* thus approaches fraud on the market theory from the discretionary area of class action certification. This case—by contrast—directly raises the substantive issue of the elements of the Rule 10b-5 implied cause of action.

Indeed, this Court could resolve *Basic Inc.* by affirming some form of class certification without approving the fraud on the market theory. This petition, on the other hand, directly and unavoidably raises the issue of the theory's validity. Moreover, rejection of the fraud on the market theory does not mean the end of class actions under § 10(b). It will still be possible to try common issues of fact and leave individual reliance, along with individual damages, to a later date. Although this procedure may result in smaller, more manageable classes, that is not bad. Plaintiffs would be forced to define classes with some degree of attention to the actual claims, rather than alleging the largest possible class for *in terrorem* effect. In *Blue Chip Stamps*, this Court stated that "the inexorable broadening of the class of plaintiff who may sue in this area will ultimately result in more harm than good." 421 U.S. at 747-48. Fear of such a limitation is thus no reason to discard reliance.

CONCLUSION

The fraud on the market theory abolishes the reliance element of a cause of action for damages under Section 10(b) as unnecessary—an anachronism. It rejects the congressional judgment that such reliance is a necessary part of the securities laws. By removing any connection between deceptive conduct and plaintiff's decision to purchase or sell, the fraud on the market theory completely undermines one of the purposes of

the securities laws: encouraging investors to read congressionally mandated disclosures. The theory also expands the class of plaintiffs who may sue beyond those investors Congress intended to protect.

Full and fair consideration of the fraud on the market theory can best be had in the context of this case. Accordingly, petitioners respectfully request that this Court grant their petition and hear this case separately or join it with *Basic Inc.* by ordering an expedited briefing schedule in the present case, or by scheduling oral argument in *Basic Inc.* late in the Term so that both cases can be resolved simultaneously.

Respectfully submitted,

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APPENDIX

Opinion of United States Court of Appeals, Fifth Circuit

UNITED STATES COURT OF APPEALS

FIFTH CIRCUIT

No. 86-1680

May 27, 1987

HANNAH FINKEL,

Plaintiff-Appellant,

—v.—

DOCUTEL/OLIVETTI CORPORATION, et al,

Defendants-Appellees.

Jules Brody, Stull, Stull & Brody, New York City, W.D. Masterson, Kilgore & Kilgore, Inc., Dallas, Tex., for plaintiff-appellant.

Steven M. Woghin, Robert F. Henderson, Dallas, Tex., for Docutel/Olivetti, DeMoss & Meredith.

George M. Newcombe, David E. Massengill, New York City, for Ing. Olivetti & C., DeBenedetti, Fubini & Piol.

Appeal from the United States District Court for the Northern District of Texas.

Before JOLLY and DAVIS, *Circuit Judges*,
and FELDMAN,* *District Judge*.

FELDMAN, *District Judge*:

This appeal asks whether the fraud on the market theory applies in 10b-5 securities fraud suits when the securities at issue were purchased in the open market. In the limited context of this opinion, we hold that the answer is yes and, therefore, proof of reliance on specific misconduct in the purchase or sale of a security in the open market is not a requisite key to recovery. Thus, we affirm in part and reverse in part, and remand to the district court for proceedings consistent with the parameters set here.

I. BACKGROUND

Plaintiff, Hannah Finkel, brought this action on behalf of herself and other purchasers of the stock of Docutel/Olivetti Corporation alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission. In the complaint, plaintiff pleaded the fraud on the market theory to satisfy the reliance element of her claim. She alleged that Docutel's inventories were materially overstated, that defendants failed to disclose the true value of Docutel's inventories (which artifically inflated the market price of Docutel), and that she suffered damages because she relied on the integrity of the market price when she purchased Docutel's stock. The stock was purchased in the open market.

Docutel is a Delaware corporation that was formed to produce automatic teller machines. In 1982, Docutel, by merg-

* District Judge for the Eastern District of Louisiana, sitting by designation.

ing with Olivetti Corporation of America,[1] expanded its product line to include typewriters, personal computers, and related equipment. Olivetti Corporation is the United States subsidiary of defendant Ing. C. Olivetti & C., S.p.A., an Italian corporation. Defendants B.J. Meredith and Emmet R. DeMoss were officers of Docutel during the period at issue. Defendants Carlo DeBenedetti and Simone Fubini were officers of Olivetti and directors of Docutel. And defendant Elserino M. Piol was a director of both corporations.

Docutel's stock trades in the over-the-counter market (a reporting network in which transactions in securities are reported to the National Association of Securities Dealers for publication). It is a publicly owned and traded corporation. As of October 1, 1983, Docutel had issued and outstanding 6.8 million shares of common stock held by approximately 3,200 public shareholders. On December 5, 1983, plaintiff purchased 300 shares of Docutel at $14^{5}/_{8}$ per share for a total price of $4,474.75. On February 16, 1984, just months later, Docutel announced a projected net loss of $14,000,000 for 1983. This projection proved to be low, and Docutel's form 10-K for 1983 reported a loss of $18,263,000, including $10,900,000 of inventory write-downs. On April 6, 1984, Docutel's stock price closed at $7^{1}/_{4}$, significantly below its 1983 high of $38^{7}/_{8}$.

Plaintiff claims that Olivetti, by virtue of its 46% interest in Docutel, controlled Docutel and used that control to hide its losses in Olivetti of America. Her central complaint is that throughout 1983 Docutel purchased Olivetti Corporation of America's inventories at inflated prices,[2] but that Docutel concealed this fact until early 1984 when the year-end audit forced it to take large inventory write-downs. The inventory write-downs totalled $10,900,000 of which approximately

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1 After the merger, a subsidiary of Olivetti owned 46% of Docutel's stock. In August 1985, Docutel was merged into a wholly owned subsidiary of Docutel, and re-named Olivetti, U.S.A., Inc.

2 Docutel paid $10,163,000 in the first quarter, $34,940,000 in the second quarter, and $57,002,000 in the third quarter.

$10,100,000 was recorded in the fourth quarter.[3] The essential thrust of her charge is that the delay in taking the write-downs defrauded purchasers of Docutel stock who bought it between the release of Docutel's form 10-Q for the first quarter of 1983 and the subsequent statements projecting losses for 1983, by causing them to buy at an inflated price.[4]

Defendants moved to dismiss the complaint under Fed. R.Civ.P. 12(b)(6) because plaintiff failed to plead reliance on any specific misleading statement, and under Fed.R.Civ.P. 9(b) for failure to plead fraud with particularity. Discovery and class certification were deferred pending a ruling on the motion to dismiss.[5] On August 20, 1983, [sic] the district court dismissed the complaint on the ground of failure to plead individual reliance. The court held that under *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983), the fraud on the market theory applies only to the special example of unmarketable securities. Since the plaintiff claimed only that "the price was too high when she bought it", rather than that Docutel's stock was unmarketable at any price, the court held that her failure to plead individual reliance was fatal and the case was dismissed. We hold the court read *Shores v. Sklar* too narrowly.

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3 In its 1983 form 10-K, Docutel stated:

"In 1983, the Company's record keeping procedures and accounting staff were strained due to the significant growth in transaction volume resulting from the merger with Olivetti Corporation, attrition of personnel, and the transfer in the second half of 1983 of the OPD accounting function from Tarrytown, New York, to the Company's headquarters in Irving, Texas."

4 Plaintiff seeks to bring this action on behalf of all purchasers of the common stock of Docutel who bought it between April 29, 1983 and February 16, 1984.

5 Because no discovery was taken, the record is spare; it consists of only basic pleadings.

II. DEVELOPMENT OF THE FRAUD ON THE MARKET THEORY

Reliance is one of the cornerstones of a Rule 10b-5 claim. *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977). The Rule 10b-5 cause of action is rooted in the ancient common law tort of deceit, which required proof of reliance on the defendant's specific misrepresentation. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 547 (5th Cir. 1981), *affirmed in part and reversed in part*, 459 U.S. 375, 102 S.Ct. 683, 74 L.Ed.2d 548 (1983). Proof of reliance establishes that the damaged party was induced to act by the defendant's conduct; it defines the causal link between defendant's misconduct and the planitff's decision to buy or sell securities. *Id.; Dupuy, supra*, at 1016. It is the generally applied bond between bad conduct and damages. It confirms the rather universal notion that one damaged ought not be rewarded for one's own deficient conduct.

The issue presented here, however, is not whether reliance is an element of Rule 10b-5, but how it may be proved, and who must prove it.

Two doctrines have evolved which assert how a plaintiff may satisfy the reliance element without specially proving that he or she relied directly on some active misrepresentation: the *Affiliated Ute* presumption, and the "fraud on the market" theory. They interact.

A. The *Affiliated Ute* Presumption

In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), the Supreme Court held that the 10b-5 plaintiff does not have to present positive proof of reliance in all securities fraud settings. Two of the defendants in *Affiliated Ute* bought stock from the plaintiffs without disclosing to them the existence of a secondary market in which the securities could be sold at a higher price. The defendants were not only aware of the secondary market, but had developed it themselves. The Court explained why positive proof of reliance was not required:

> "It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation . . . .
>
> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.

Id., 406 U.S. at 153-54, 92 S.Ct. at 1472 (citations omitted).

Courts applying *Affiliated Ute* have doctrinally invoked a rebuttable presumption of reliance based on proof of materiality in cases alleging deception by non-disclosure of information.[6] In *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978), this Court summarized the pattern that emerged after *Affiliated Ute*:

> "Where a 10b-5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information. Upon a failure of proof on the issue, defendant loses. But this presumption of reliance is not conclusive. If defendant can prove that plaintiff did not rely, that is, that plaintiff's decision would not have been affected even if defendant had disclosed the omitted facts, the plaintiff's recovery is barred."

574 F.2d at 262 (footnotes omitted).

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6 The Supreme Court did not decide whether the presumption should be conclusive or rebuttable. In fact, the word "presumption" does not even appear in the *Affiliated Ute* opinion. *See Chris-Craft Industries v. Piper Aircraft Corp.*, 480 F.2d 341, 400 (2d Cir.), Mansfield, Jr., concurring and dissenting, *cert. denied*, 414 U.S. 910, 94 S.Ct. 231, 38 L.Ed.2d 148, and at 414 U.S. 924, 94 S.Ct. 234, 38 L.Ed.2d 158 (1973).

A court must, therefore, analytically characterize a 10b-5 action as either primarily a nondisclosure case (which would make the presumption applicable), or a positive misrepresentation case. Actually, the division of 10b-5 actions into these two categories is justified by the Rule itself.[7] Cases involving primarily a failure to disclose implicate the first and third subsections of Rule 10b-5; cases involving primarily a misstatement or failure to state a fact necessary to make statements made not misleading implicate the second subsection (which is the only subsection of the Rule that specifically mentions the active misrepresentation concept of prohibited conduct). *Huddleston v. Herman & MacLean*, 640 F.2d at 548.

B. The Fraud on the Market Theory

We turn briefly from judicial literature to economic doctrine.

The fraud on the market theory is premised on the hypothesis that the market price of a security, in an open market environment as opposed to a private transaction between seller and buyer, accurately reflects the value of that security if all

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7 Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, or misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240 10b-5 (1986). Although the sections are lettered, we refer to them numerically because the *Affiliated Ute* opinion does.

relevant information has been disclosed in the marketplace.[8] When one fails to disclose or misrepresents material information about a security, the market's efficient pricing mechanism is skewed and the price of the security is distorted. A purchaser or seller who relies on the market to accurately value the security suffers damages if the market does not have all the information. Thus, the fraud on the market theory rejects the traditional notion of the investor who acts after carefully examining all available information.[9] It says investors need not, and do not, act that way in an open market transaction because they have a right to presume the market's integrity. It constructs an environment which is hospitable to the reliance presumption of *Affiliated Ute*. In place of the traditional model it substitutes a market model in which the explicit assumption is that the market relied on the alleged deception, and it rejects the conceptual need to inquire whether or not the

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8 This is called the "efficient market" model. "An efficient capital market is one in which the price of the stock at a given time is the best estimate of what the price will be in the future." Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.Law. 1, 4 n. 9 (1982). The doctrine states that the price of securities is a function of the information the market possesses, both positive and negative, assuming all information is disclosed. *In re LTV Securities Litigation*, 88 F.R.D. 134, 144 (N.D.Tex. 1980). Although not all scholars agree about its validity, disciples of the theory find proof of its validity in the theory of random selection. *See id.* at 145 (various institutional investors rely on the efficient market hypothesis by purchasing a random cross-section of stocks). The efficient market model is thought to operate in open or "developed" market transactions, which simply refers to some large, impersonal actively traded market. *See* Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143, 1154 (1982).

9 *See* Fischel, 38 Bus.Law. 1, 2-5; Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143, 1159 (1982) ("[R]ecent scholarship suggests that the dissenters' vision of individual investors reading and relying upon information required to be disclosed in registration statements and the like is suspect. Most SEC disclosure documents not only go unread by their intended recipients but in fact 'can be used effectively only by market professionals.' ") (quoting H. Kripke, The SEC and Corporate Disclosure at 14 (1979)).

injured party did. The market becomes the theoretical agent of the investor.[10]

III. HOW COURTS HAVE USED THE THEORY

The premiere fraud on the market case is *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976), in which the court held that the plaintiffs did not have to prove direct reliance on false representations. Instead, they could prove reliance on "the supposition that the market price is validly set and that no suspected manipulation has artificially inflated the price." *Id.* at 907. The court in *Blackie* relied heavily on *Affiliated Ute*, extrapolating the principle that direct proof of reliance is unnecessary when it imposes an unreasonable evidentiary burden. *Id.* at 908. The court gave content to what became the post-*Affiliated Ute* pattern by establishing a presumption of reliance. *Id.* at 906.

The fraud on the market theory has been adopted, in some form, by every Circuit considering it.[11] It has been favorably

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10 One way of perceiving the market's role is as "a transmission belt linking the misrepresentation and the individual purchaser or seller." *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D.Tex. 1980). The theory has special and obvious appeal in class actions because the need to prove a personalized reliance by each class member is avoided.

11 *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed.2d 467 (1975); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027, 103 S.Ct. 434, 74 L.Ed.2d 594 (1982); *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983); *Levinson v. Basic, Inc.*, 786 F.2d 741 (6th Cir. 1986); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522 (7th Cir. 1985); *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert denied*, _____ U.S. _____, 107 S.Ct. 94, 93 L.Ed.2d 45 (1986); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976); *Arthur Young & Co. v. United States District Court*, 549 F.2d 686 (9th Cir.) *cert. denied*, 434 U.S. 829, 98 S.Ct. 109, 54 L.Ed.2d 88 (1977); *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979); *T.J. Raney & Sons, Inc. v. Fort Cobb Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026, 104 S.Ct. 1285, 79 L.Ed.2d 687 (1984); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert.*

received by many scholars.[12] The Securities and Exchange Commission accepts the efficient market hypothesis, which underlies the fraud on the market theory.[13] Even those who question the efficient market hypothesis concede that the hypothesis, and the fraud on the market theory that is based on it, are widely accepted.[14]

IV. THE DECISION IN *SHORES v. SKLAR*

This Circuit, *en banc*, addressed the fraud on the market theory in *Shores v. Sklar*, 647 F.2d 462 (1981),[15] and the parties agree that it controls the issue before the Court. They disagree, however, on what *Shores* means. Appellant interprets *Shores* as broadly embracing the fraud on the market theory. Appellant argues that *Shores* extended the applicability of the fraud on the market theory beyond securities trading in active, open

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denied, 469 U.S. 1132, 105 S.Ct. 814, 83 L.Ed.2d 807 (1985); *Wachovia Bank & Trust v. National Student Marketing Corporation*, 650 F.2d 342, 358 (D.C.Cir. 1980), *cert. denied*, 452 U.S. 954, 101 S.Ct. 3098, 69 L.Ed.2d 965 (1981).

12 *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. Rev. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash. & Lee L.Rev. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo.Wash.L.Rev. 627 (1982); Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143 (1982).

13 SEC Securities Act Release No. 6383, 47 Fed. Reg. 11,380 (1982); SEC Securities Act Release No. 6235, Proposed Comprehensive Revision to the System for Registration of Securities Offerings, [1980 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 82,649, at 83,484; Executive Summary of Securities Act Releases 6331-38, Proposed Rulemaking to Implement the Integrated Disclosure System, [1981-1982 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 83,016, at 84,479. *See also* Pickholz and Horahan, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 Wash. and Lee L.Rev. 943 (1982).

14 *See, e.g.*, Gordon and Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U.L.Rev. 760, 761-62 (1985).

15 In *Rifkin v. Crow*, 574 F.2d 256, 263-64 (5th Cir. 1978), the court discussed the fraud on the market theory without deciding whether to endorse it.

markets to include newly issued securities as well. Appellees counter that *Shores* recognized only a closely circumscribed fraud on the market cause of action—a cause of action limited to securities that, except for the alleged fraud, would not have been offered in the market at any price. With these divergent views in mind, we turn to *Shores v. Sklar*.

The plaintiff in *Shores*, Bishop, alleged the existence of an elaborate scheme to defraud investors through the issuance of worthless bonds. The district court, on the defendants' motion to dismiss, treated the motion as one for summary judgment and entered judgment on the ground that there was no genuine issue of material fact as to plaintiff's reliance on the Offering Circular for the bonds; Bishop had admitted in answers to interrogatories that he had not read nor was he aware of the allegedly misleading Offering Circular through which the bonds were marketed.

All twenty-two members of the *en banc* Court agreed that the district court's ruling should be affirmed as to Bishop's claim under Rule 10b-5(2), the second subsection of the Rule:

> "Bishop alleged that the Offering Circular contained material misrepresentations and failed to state material facts necessary to make the statements made not misleading. At the same time, he admitted that he never read or otherwise relied on the Offering Circular. If the *Ute* presumption applied to these nondisclosures, Bishop's admission rebuts it. Bishop's claim that he was deceived by the misrepresentations and omissions of the Offering Circular was correctly dismissed by the district court because of his failure to read or even seek to read the Offering Circular."

Shores at 468.[16]

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16 *See also Shores* at 481 (Randall, J., dissenting). ("In this case the existence of reliance has been definitively disproved by Bishop's admission that he did not read or even seek to read the offering circular. And, as the majority opinion correct [sic] concludes, presumptive reliance has been rebutted by the same admission."

The Court divided sharply over whether the dismissal of the 10b-5(2) claim based on lack of reliance on the Offering Circular also controlled disposition of the claims made under 10b-5(1) and (3). A twelve judge majority held that Bishop's admitted lack of reliance was not determinative as to claims made under 10b-5(1) and (3). *Id.* at 469. The Court reversed the district court's dismissal as to those claims and remanded, instructing that Bishop be given the opportunity to prove that the defendants conspired to bring to market securities that were not entitled to be marketed, that he relied on the bonds' availability in the market as an indication of their genuineness, and that as a result of the scheme to defraud he suffered a loss. *Id.* at 469-70. Focusing on the language of Rule 10b-(5)(1) and (3), the first and third subsections, the Court noted that these provisions would allow Bishop to show a scheme to defraud or course of business which operates as a fraud. It is important and instructive to note the Court concluded:

> "Whenever the rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The 'reliance' that produces causation in the latter type of case cannot come from reading a document . . . . rule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer. The rule is recognized also to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities.

Id. at 472.

We hold, therefore, that *Shores* permits a plaintiff to assert a fraud on the market theory under 10b-5(1) and (3) but not under 10b-5(2). This conclusion is consistent not only with the language of *Shores*, but with the *Shores* result—reversal as to the dismissal of claims under 10b-5(1) and (3) and affirmance as to the dismissal of claims under 10b-5(2). Other Circuits

have gone even farther, and recognize the fraud on the market theory under10b-5(2)[17] We do not because *Shores* does not.[18]

It is clear, then, that courts deciding whether a fraud on the market claim is viable must first characterize the allegations of the complaint as falling under 10b-5(1) and (3), and not under 10b-5(2). This is not, however, a task for which there is no guide. As we have discussed, the process of characterizing a complaint in this fashion springs from the Supreme Court's holding in *Affiliated Ute*, and was discussed in *Rifkin v. Crow.*[19]

V. THE COMPLAINT AND *SHORES v. SKLAR*

Turning to plaintiff's complaint, we find that it tracks the language of all three subsections of Rule 10b-5.[20] Under *Shores*, any fraud on the market claim under subsection (2) is barred by plaintiff's failure to allege that she read or relied on any of the documents now claimed to have misrepresented the

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17 *See Peil v. Speiser*, 806 F.2d 1154, 1162-63 (3d Cir. 1986) (fraud on the market theory pertains to Rule 10b-5(b) claims as well as claims brought under clauses (a) and (c)); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984) (adopting fraud on the market theory as to all claims under 10b-5); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975).

18 We disagree with the holding of *Lipton* to the extent that it reads *Shores* to permit a fraud on the market theory under 10b-5(2). We note, however, that we find its reading of *Shores* otherwise consistent with our own.

19 See 574 F.2d 256, 263.

20 Plaintiff's complaint alleges:

"26. Throughout the class period, defendants, pursuant to a common course of conduct or conspiracy and using the means and instrumentalities of interstate commerce (including the United States mails), knowingly and/or recklessly (a) employed devices, schemes and artifices to defraud; (b) omitted to state material facts necessary in order to make the D/O statements made in light of the circumstances in which they were made not misleading; and (c) engaged in acts, practices and a common course of business which operated as a fraud or deceit upon plaintiff and the class as hereinafter alleged."

financial condition of Docutel. As to claims under Rule 10b-5(2), therefore, we affirm the district court's dismissal of the complaint.

But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel. That is the core of this case on remand: whether Olivetti forced Docutel to take worthless inventories and whether the alleged nondisclosure of that fact inflated the stock price and caused the damages complained of.

The fact that plaintiff's complaint lists inaccuracies in Docutel's three quarterly filings with the SEC does not mean plaintiff's complaint fails completely. It fails only under the 10b-5(2) claim. Issuers of securities are under a continuing obligation to make disclosure. Because of the continuing obligation to make disclosure, "it is difficult to envision a pure case of nondisclosure when the issuer is a publicly reporting company, since the failure to make complete disclosure would make prior statements misleading".[21] The fact that Docutel complied with its obligation to file form 10-Qs with the SEC cannot limit all plaintiffs to relief only under 10b-5(2). The presence of disclosure documents may prevent this from being a case of pure nondisclosure; it does not, however, prevent this case from being primarily one of nondisclosure, as in *Affiliated Ute*. The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take

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21 Grzebielski, *Should the Supreme Court Recognize General Reliance in Private Actions under Rule 10b-5?*, 36 Baylor L.Rev. 335, 339 n. 23 (1984).

worthless inventories without disclosing that fact in the market place; if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3). Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).[22]

On remand, Finkel will not be limited to proof that the securities were "unmarketable" because of the defendants' alleged fraud. The instruction to the lower court in *Shores* that "[i]f Bishop proves no more than that the bonds would have been offered at a lower price or higher rate, rather than that they should never have been issued or marketed, he cannot recover" (*Shores* at 470) was tailored to the facts of that case.[23] Although there was some doubt in *Shores* about whether Bishop purchased in the primary market as an initial purchaser from the offering, or in the secondary market,[24] it is clear that the market for the bonds in *Shores* (industrial development bonds of the town of Frisco City, Alabama) does not represent the active, efficient market for which the fraud on the market theory was initially conceived. (As noted in *Shores*, bonds of that type are usually not traded in a secondary market. *Id.* at 467). In contrast, Docutel's stock traded in the over-the-

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22 The dissent in *Shores* argued that the requirement of positive proof of reliance under 10b-5(2) is a "dead letter" if a plaintiff can use the broad language of 10b-5(1) and (3) to reach conduct that is also actionable under 10b-5(2). *Shores* at 486 (Randall, J., dissenting). The *Shores* majority rejected that argument. *See Shores* at 471-72. We, bound by *Shores*, also reject it.

23 The distinction between facts that decrease the value of securities and facts that make securities unmarketable has drawn some criticism. *See* Note, 90 Harv.L.Rev. 1143, 1158 (limitation to totally unmarketable securities is arbitrary); Black, N.C.L.Rev. 435, 453 (distinction is, if there is one, difficult to draw); Grzebielski, 36 Baylor L.Rev. 335, 341.

24 The district court found that Bishop purchased from the primary offering, and the *Shores* majority did not purport to reverse that finding. *Shores* at 467.

counter market.[25] The critical fact is the presence of a market in which the security is actively traded.[26] The *Shores* limitation of Bishop's claim to proof that the bonds were unmarketable is simply a rule formulated for newly issued securities. We pause to examine that statement because it more sharply focuses the holding of *Shores*: The process of issuing securities is different from the process of valuing securities; the issuance price is set, not by market forces, but by the issuer and managing underwriter.[27] While the price is related to the market's valuation process because the underwriter and issuer set the price in relation to the market price of similar securities already in the market, the causal nexus between price and market is not direct.[28] The majority in *Shores* simply recognized that a Rule 10b-5 action based on the fraud on the market theory could embrace a claim for a fraud that resulted in the issuance of worthless securities as well as a fraud that inflated the price of a security.[29]

On remand, defendants will have an opportunity to rebut the presumption of reliance established by proof of materiality of the alleged misconduct, if plaintiff can show materiality. Defendants may do so in two ways: 1) by showing, upon the

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25 Appellees imply that the fact that Docutel traded in the OTC market, which is not an exchange like the New York or American stock exchanges, and the number of Docutel shareholders (3200) support the district court's ruling. These facts may have some relevance to determining whether the market for Docutel's stock was efficient, but that issue is not before us. If plaintiff can establish materiality of the misconduct, and through it a presumption of reliance, defendants may rebut the presumption by showing that the market did not react to the alleged fraud.

26 *Lipton*, 734 F.2d at 746 n. 8; *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma, Irrigation Authority*, 717 F.2d 1330, 1332.

27 *See* Note, *Fraud on the Market: An Emerging Theory of Recovery under SEC Rule 10b-5*, 50 Geo.Wash.L.Rev. 627, 651 & n. 137 (1982).

28 *Lipton* at 746.

29 The Court mentioned *Rifkin v. Crow* for the proposition that a 10b-5 claim under subsections (1) and (3) would be viable where the plaintiff alleged "a scheme to inflate common stock prices by misleading statements." *Shores* at 472.

shifting of the burden to defendant, that the nondisclosures did not affect the market price; or 2) that plaintiff would have purchased the stock at the same price even if she had known the information that was not disclosed, or that she actually knew the information that was not disclosed to the market.[30]

VI. CONCLUSION

We need not address, point by point, appellees' numerous arguments against the fraud on the market theory in general. Simply stated, the fraud on the market theory has been widely accepted by impressive scholars and many courts. Appellees' only remaining argument, that the district court's dismissal of the complaint may be affirmed because the complaint does not plead fraud with particularity, is unavailing at this point. The district court did not rule on defendants' motion to dismiss under Fed.R.Civ.P. 9(b) and defendants may re-urge it on remand.

The judgment dismissing plaintiff's complaint is vacated to the extent stated herein, and the cause is remanded for further proceedings consistent with this opinion on the issue of whether the alleged failure to disclose the purchase of inflated inventories entitles plaintiff and the class, if one is certified, to recover damages under 10b-5(1) and (3).

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30 *Peil v. Speiser*, 806 F.2d 1154, 1163; *Blackie v. Barrack*, 524 F.2d 891, 906.

Order

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

CA 3-84-0566-T

[Filed August 20, 1986]

HANNAH FINKEL,

Plaintiff,

—v.—

DOCUTEL/OLIVETTI CORPORATION, et al.,

Defendants.

ORDER

Plaintiff has alleged a securities fraud cause of action under Rule 10b-5 of the Securities and Exchange Commission. She has alleged what is called a "fraud upon the market" cause of action.

It is clear under the ruling in the case of *Shores v. Sklar*, 647 F.2d 462 (5th 1981), that such a cause of action in the Fifth Circuit is very narrow, and not as broad as it is in the Ninth Circuit. See *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1978). Plaintiff's Complaint is not that the security that she bought would never have been accepted by the market except for the alleged fraudulent conduct of the Defendants, but that the price of the security was too high when she bought it. *Shores v. Sklar*, above, makes it clear that in such a case, a Plaintiff must allege and prove individual reliance and not merely general reliance.

Therefore, it is ORDERED that Defendant's Motion to Dismiss is granted and Plaintiff's Complaint is dismissed.

Signed this 20th day of August, 1986.

/s/ ROBERT B. MALONEY

Robert B. Maloney
United States District Judge

Certified a true copy of an instrument
on file in my office on 9/18/86

NANCY HALL DOHERTY, *Clerk*,
U.S. District Court,
Northern District of Texas
By _____ Deputy

Judgment

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 86-1680

D.C. Docket No. CA3-84-0566-T

[Filed May 27, 1987]

HANNAH FINKEL,
Plaintiff-Appellant,

versus

DOCUTEL/OLIVETTI CORPORATION, ET AL.,
Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Texas

Before:

JOLLY and DAVIS, *Circuit Judges,*
and FELDMAN*, *District Judge.*

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the District Court in this cause is reversed, and the cause is remanded to the District Court for further proceedings in accordance with the opinion of this Court.

IT IS FURTHER ORDERED that each party bears its own costs on appeal.

May 27, 1987

ISSUED AS MANDATE: June 19, 1987

A true copy
Test: GILBERT F. GANUCHEAU
Clerk, U.S. Court of Appeals, Fifth Circuit

By _____
Deputy

New Orleans, Louisiana
August 4, 1987

Text Of Statute Relied On

SECURITIES EXCHANGE ACT OF 1934
§ 10(b), 15 U.S.C. § 78j(b)

§ 78j. *Manipulative and deceptive devices*

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Text Of Rules Relied On

SECURITIES AND EXCHANGE COMMISSION
RULE 10b-5, 17 C.F.R. § 240.10b-5

§ 240.10b-5 *Employment of manipulative and deceptive devices.*

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Complaint

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

CA 3-84 0566 F

[Filed April 12, 1984]

HANNAH FINKEL,

Plaintiff,

—v.—

DOCUTEL/OLIVETTI CORPORATION, ING., C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

Defendants.

CLASS ACTION COMPLAINT

TRIAL BY JURY DEMANDED

Plaintiff, by her attorneys, for her complaint, alleges the following upon information and belief, except paragraph "2", which is alleged upon knowledge.

JURISDICTION AND VENUE

1. (a) The claims alleged herein arised under Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.* (the "Exchange Act"), and Securities and Exchange Commission Rule 10b-5 promulgated thereunder.

(b) Jurisdiction is conferred upon this Court by Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

(c) This Court has personal jurisdiction of the defendants pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

(d) Many of the acts and transactions constituting the violations of law herein complained of occurred within this judicial district. In addition, each of the defendants is found in, is an inhabitant of or transacts business in this judicial district.

THE PARTIES

2. Plaintiff is a resident of the State of New York, County of Kings. On December 5, 1983, plaintiff purchased 300 common shares of Docutel/Olivetti Corporation ("D/O") at $14 5/8 per share, at a total price of $4,474.75.

3. (a) D/O is a Delaware corporation with its executive offices located at 106 Decker Court, Irving, Texas. D/O and its subsidiaries develop, make, market and service automatic teller machines; teller terminal systems; electronic typewriters and writing systems; business computer systems; computers and consumer products.

(b) As of October 1, 1983, D/O had issued and outstanding 6,800,000 shares of common stock, owned by more than 3,200 shareholders. D/O's shares are traded in the over-the-counter market.

4. Ing. C. Olivetti & C., S. p. A ("ICO") is an Italian corporation with its executive offices located at Via Gervis 77 10015 Ivrea (To) Italy. ICO and its subsidiaries manufacture and sell world wide information processing products, such as banking automation systems, business computer systems and other information systems and products. Since 1982 ICO has controlled D/O as more fully hereinafter described.

5. On September 14, 1982, as a result of a merger between a subsidiary of ICO and D/O, ICO's beneficial ownership of outstanding common stock of D/O increased from approximately 20% to approximately 46%. D/O also issued a warrant to a subsidiary of ICO to acquire an additional 500,000 shares of common stock (4%) at $32 per share between January 1, 1984 and June 30, 1984.

6. At all relevant times defendant B. J. Meredith ("Meredith") was and presently is Chairman of the Board and Chief Executive Officer of D/O. As of March 11, 1983, Meredith was the beneficial owner of 46,688 shares of D/O's outstanding common stock.

7. At all relevant times defendant Emmett R. DeMoss, Jr. ("DeMoss") was and presently is Executive Vice President, Chief Financial Officer and a director of D/O.

8. At all relevant times defendant Carlo DeBenedetti ("DeBenedetti") was and presently is Vice Chairman and Managing Director and Chief Executive Officer of ICO and a director of D/O. As of March 11, 1983, ICO owned approximately 3,133,000 shares (46%) of D/O's outstanding common stock.

9. At all relevant times defendant Simone Fubini ("Fubini") was and presently is Chief Operating Officer of ICO and a director of D/O.

10. At all relevant times defendant Elserino M. Piol ("Piol") was and presently is a representative of ICO who had been designated and acted as a director of D/O.

CLASS ACTION ALLEGATIONS

11. Plaintiff brings this action as a class action pursuant to Rules 23(a) and (b)(3) of the *Federal Rules of Civil Procedure* on behalf of a class consisting of all persons who, during the period April 29, 1983 through February 16, 1984, purchased common stock of D/O, and who were damaged thereby. Excluded from the class are the defendants herein, members of the immediate family of each of the individual defendants, and the legal representatives, heirs, successors, assigns or subsidiaries of any of the defendants.

12. The members of the class are so numerous that joinder of all members is impracticable, as evidenced by the fact that many hundreds of thousands of shares of D/O's common stock were purchased by public investors in the open market during the class period.

13. The claims of plaintiff are typical of those of the class and their common interest is to obtain relief for themselves and the class for the violations of law set forth herein.

14. Plaintiff will fairly and adequately protect the interests of the class and has retained counsel competent and experienced in class action securities litigation to prosecute this action.

15. A class action is superior to other available methods for the fair and efficient adjudication of this controversy since the class is so numerous and its membership so widespread that joinder of all members is impracticable. Furthermore, as individual damages of each class member may be relatively small, the expense and burden of non-class litigation may very well be impossible for many members seeking to redress their wrongs.

16. Questions of law and fact common to the members of the class exist and predominate over any questions affecting only individual members of the class. Among the questions of law and fact common to the class are whether the federal securities laws as alleged herein have been violated by the defendants and the appropriate relief for the class.

17. On April 29, 1983 the Wall Street Journal reported that D/O had a net loss for the quarter ended March 31, 1983 in the amount of $1,332,000.

18. (a) In its report to the Securities & Exchange Commission ("SEC") for the quarter ended March 31, 1983 D/O reported, among other things, the same loss as was reported in the Wall Street Journal.

(b) In such quarterly report D/O also reported that the net revenues and cost of revenues for the three months ended March 31, 1983 amounted to $51,798,000 and $37,353,000, respectively.

(c) In D/O's balance sheet at March 31, 1983 the inventories and total assets amounted to $62,249,000 and $212,427,000, respectively.

(d) In said quarterly report it was stated in footnote 1 of the Notes to Consolidated Condensed Financial Statements that:

> "In the opinion of management, the accompanying consolidated condensed financial statements contain all adjustments necessary to present fairly the Registrant's financial position as of March 31, 1983 . . .; and the results of operations and changes in financial position for the three months ended March 31, 1983 . . ."

(e) In such quarterly report footnote 5 of the Notes to Consolidated Condensed Financial Statements disclosed that ICO sold inventories during the three months ended March 31, 1983 to D/O in the amount of $10,163,000.

19. On July 29, 1983, the Wall Street Journal reported that D/O had a net loss for the quarter ended June 30, 1983, in the amount of $1,522,000.

20. (a) In its report to the SEC for the quarter ended June 30, 1983 D/O reported, among other things, the same loss as was reported in the Wall Street Journal.

(b) In such quarterly report D/O also reported that the net revenues and the cost of revenues for the three months ended June 30, 1983 amounted to $58,136,000 and $41,290,000, respectively and the net revenues and cost of revenues for the six months ended June 30, 1983 amounted to $109,934,000 and $78,697,000, respectively.

(c) In D/O's balance sheet at June 30, 1983 the inventories and total assets amounted to $74,607,000 and $227,343,000, respectively.

(d) In such quarterly report it was stated in footnote 1 of the Notes to Consolidated Condensed Financial Statements that:

> "In the opinion of management, the accompanying consolidated condensed financial statements contain all the adjustments necessary to present fairly the Registrant's financial position as of June 30, 1983 . . .; and the

results of operations and changes for the three months and six months ended June 30, 1983 . . ."

(e) In such report for the quarter ended June 30, 1983, footnote 6 of the Notes to Consolidated Condensed Financial Statements disclosed that ICO sold inventories during the three months ended June 30, 1983 to D/O in the amount of $34,940,000.

21. On November 1, 1983, the Wall Street Journal reported that D/O had net income for the quarter ended September 30, 1983 in the amount of $710,000 and a net loss of $812,000 for the nine months ended September 30, 1983.

22. (a) In its report to the SEC for the quarter ended September 30, 1983 D/O reported, among other things, the same net income for the three months ended September 30, 1983 and the same loss for the nine months ended September 30, 1983 as was reported in the Wall Street Journal.

(b) In D/O's report for the quarter ended September 30, 1983 to the SEC D/O also reported that the net revenues and the cost of revenues for the three months ended September 30, 1983 amounted to $60,394,000 and $40,187,000, respectively, and the net revenues and cost of revenues for the nine months ended September 30, 1983 amounted to $170,328,000 and $118,884,000, respectively.

(c) In D/O's balance sheet at September 30, 1983 the inventories and total assets amounted to $75,180,000 and $240,095,000, respectively.

(d) In the report for the quarter ended September 30, 1983, it was stated in footnote 1 of the Notes to Consolidated Condensed Financial Statements that:

"In the opinion of management, the accompanying consolidated condensed financial statements contain all adjustments necessary to present fairly the Registrant's financial position as of September 30, 1983 . . .; and the results of operations and changes in financial position for the three months and nine months ended September 30, 1983 . . ."

(e) In the report for the quarter ended September 30, 1983, footnote 6 to the Notes to Consolidated Condensed Financial Statements disclosed that ICO sold inventories during the quarter ended September 30, 1983 to D/O in the amount of $57,002,000.

23. On or about February 16, 1984, D/O announced that it projected a net loss of $13,000,000 for the quarter ended December 31, 1983 and a net loss for the year ended December 31, 1983 in the amount of $14,000,000. D/O had said that the loss for the year ended December 31, 1983 included a $10,000,000 pre-tax inventory write down.

24. On April 2, 1984 the Wall Street Journal reported that D/O said its previously projected net loss for 1983 of $14,000,000 was "significantly" wider.

25. The defendants knew, or were reckless in not knowing, that the inventory adjustments projected for the year ended December 31, 1983 were applicable to each of the quarters ended March 31, 1983, June 30, 1983 and September 30, 1983, and that D/O's earnings for each of the quarters then ended were substantially overstated.

26. Throughout the class period, defendants, pursuant to a common course of conduct or conspiracy and using the means and instrumentalities of interstate commerce (including the United States mails), knowingly and/or recklessly (a) employed devices, schemes and artifices to defraud; (b) omitted to state material facts necessary in order to make the D/O statements made in light of the circumstances in which they were made not misleading; and (c) engaged in acts, practices and a common course of business which operated as a fraud or deceit upon plaintiff and the class as hereinafter alleged.

27. Defendants had a duty to disclose that the reports for the quarters ended March 31, 1983, June 30, 1983 and September 30, 1983 contained financial information which was incorrect in that:

(a) The inventories at each quarter end were overstated.

(b) The net profits for the quarter ended September 30, 1983 was overstated.

(c) The net losses for the quarters ended March 31, 1983 and June 30, 1983 were understated.

(d) The cost of revenues for each of the quarters ended March 31, 1983, June 30, 1983 and September 30, 1983 were understated.

(e) Note 1 of the Notes to Consolidated Condensed Financial Statements for the quarters ended March 31, 1983, June 30, 1983 and September 30, 1983 were false and misleading in that ". . . adjustments necessary to present fairly the Registrant's financial position . . ." were not reflected.

28. Plaintiff and other members of the class, relying on the integrity of the market, purchased D/O's common shares during the class period at artificially inflated prices and were damaged thereby. Had plaintiff and other members of the class known of the materially overstated inventories, plaintiff and other members of the class would not have purchased D/O's common shares at the artificially inflated prices during the class period. The prices paid by plaintiff and other members of the class for their D/O common shares were inflated by the failure to disclose the inflated inventories, of which defendants knew or should have known, and said price did not reflect the fair market value of D/O's common stock based upon D/O's true financial condition.

WHEREFORE, plaintiff demands judgment, as follows:

(1) Determining this action is a proper class action maintainable pursuant to Rule 23 of the *Federal Rules of Civil Procedure*;

(2) That plaintiff and the other members of the class recover from D/O and the individual defendants, jointly and severally, damages caused by the acts and transactions complained of herein, together with appropriate interest;

(3) Awarding to plaintiff and the other members of the class relief as may be just and proper under the circumstances; and

(4) Awarding plaintiff and the other members of the class the costs and disbursements of this action, including reasonable fees to plaintiff's attorneys, accountants and experts.

Dated: April 11, 1984

STULL, STULL & BRODY

By: /s/ _____
6 East 45th Street
New York, NY 10017

—and—

KILGORE & KILGORE

By: /s/ _____
1800 First National Bk. Bldg.
Dallas, TX 75202

Plaintiff demands trial by jury.

Rule 28.1 List

Petitioner Docutel/Olivetti Corp. is a wholly-owned subsidiary of petitioner Ing. C. Olivetti & C., S.p.A. Ing. C. Olivetti & C., S.p.A. and its wholly-owned subsidiaries own a 20% or greater (but less than 100%) stock interest in the following companies:

Consolidated subsidiaries

Alladium Image Products, S.p.A.; Balteadisk, S.p.A.; Filli Franchini, S.r.l.; Ciesse Control System, S.r.l.; Ciesse Italia, S.p.A.; Ciesse Emilia, S.r.l.; Ciesse Lombardia, S.r.l.; Ciesse Roma, S.r.l.; Ciesse Toscana, S.r.l.; Eurofly Service, S.p.A.; Olivetti Prodest, S.p.A.; Olivetti Value Services, S.p.A.; Sixcom, S.p.A.; O.S.E.—Olivetti Systems Engineering, S.p.A.; Radiocor, S.r.l.; Tecnost, S.p.A.; Mael Computer, S.p.A.; Mael Sistemi, S.p.A.; OSAI A-B, S.p.A.; B.T.R. Elettronica, S.p.A.; CIS, S.p.A.; LART, S.p.A.; Tecnotour, S.p.A. (ex Italcontrolli, S.p.A.); Teknecomp, S.p.A.; Societa Generale Elastomeri—S.G.E., S.p.A.; Tesis, S.p.A.; Unit, S.p.A.; Societe Informatique pour l'Automation Bancaire—S.I.A.B. S.A.; TA Triumph-Adler AG; Adlerwerke vorm.Heinrich Kleyer AG; Kommanditgesellschaft TA Triumph-Adler Centrum fur Burokommunikation Hamburg GmbH & Co.; TA Triumph-Adler Centrum fur Burokommunikation Hamburg GmbH; Triumph-Adler Wohnungsbaugesellschaft GmbH; Acorn Computer Group Plc.; Laserdrive Ltd.; Olivetti Bildungs Zentrum GmbH; Olivetti Computers S.A.; Syntax Iberica S.A.; MicroAge Europe S.A.; Olivetti-Logabax; Gestion et Techniques Informatiques S.A.; O.L.I. S.A. Olivetti Lorraine Informatique; Olivetti Formation Conseil S.A.; Ambrasoft A/S; Hileia S.A.; Inforimport Lda; Olicom Lda; Rapida S.A.; Decision Data Computer S.A.; Decision Data Computer (Belgium) S.A./NV; Decision Data Computer (G.B.) Ltd.; Decision Data Computer GmbH; Hermes Precisa International S.A.; Hermes AG; Inco Service S.A.; Olivetti Corp. of Japan; Olimark S.A.

Companies accounted for using the equity method

Delphi, S.p.A.; DPES—Distribuzione Prodotti Elettronici Registratori di Cassa Sweda, S.p.A.; Gruppo Eledra, S.r.l.; Moxel, S.p.A.; IES—Industrie Elettroniche Registratori di Cassa Sweda, S.p.A.; Infogroup, S.p.A.—Informatica e servizi telematici; ISEFI, S.p.A.; CO.FI.LEX.—Compagnia Finanziaria per l'Esportazione, S.p.A.; Hermes Factor, S.p.A.; Informatica ISEFI, S.p.A.; Olivetti Finfactoring, S.p.A.; Olivetti Finfactoring Sud, S.p.A.; Olivetti Leasing, S.p.A.; Olivetti Noleggi, S.p.A.; Sicurlease, S.p.A.; Ivitec, S.r.l.; Offnet, S.p.A.; Penta Service, S.p.A.; SAPE—Societa per l'Attivita Pubblicitaria ed Editoriale, S.p.A.; SEVA—Servizi a Valore Aggiunto, S.p.A.; S.P.I.—Sistemi e Prodotti per l'Informactica, S.p.A.; Sysdata, S.p.A.; Edizioni di Comunita, S.p.A.; MicroAge Italia, S.p.A.; Elea Quality Consult, S.r.l.; B.C.S., S.p.A.; H.B.M., S.p.A.; Italcopiers, S.r.l.; Kattra Italiana, S.p.A.; Asito, S.p.A.; Armaco, S.p.A.; Tecdis, S.p.A.; Datitalia Processing, S.p.A.; Nomos Sistema, S.r.l.; Datanet Associati, S.r.l.; Tiesse Sistemi, S.p.A.; Nuova Informatica, S.r.l.; Systems & Education, S.r.l.; D.M.C., S.r.l.; Sirio, S.p.A.; Da-Progetti, S.r.l.; Cerberus Dati, S.p.A.; T 80, S.p.A.; Ofimatica Leasing S.A.; Olivetti Finfactoring Espanola S.A.; Butel Technology Ltd.; MicroAge Computer Centers GmbH; I.P.L. Systems, Inc.; MicroAge, Inc.; Transaction Management Inc.; Olicom S/A; Sphinx Ltd.; TABS Ltd.; Olivetti Finance Ltd.; Oliform Ltd.; Servicio de Informatica de Oficina (SIOSA) S.A.; IEPRO—Industria Electronica de Productos de Oficina S.A.; Multidata S/A; Locmabi S.A.; LTA S.A. Les Techniciens Associes; Dynamic Office Technologies & Services (D.O.T.S.); Dattel Services S.A.; Goldstar Software Ltd.; Gresta Data AG; T.S.L. Communications Ltd.; Conplan GmbH; Olivetti Partners C.V.; Torus Systems Ltd.; Olivetti Ventures Advisers N.V.; Peritechnologie S.A.; Triumph-Adler Leasing GmbH; Triumph-Adler Leasing GmbH & Co. KG.

Companies accounted for using the cost method

Editrice Italiana Software—E.I.S., S.p.A.; Promozione per la Media Impresa—Promedia, S.p.A.; Syntax Factory Automation, S.p.A.; N.C. Programs, S.r.l.; Meccontrol, S.r.l.; 144 GET, S.r.l.; EDIPASS—Elaborazione Dati Istruzione Professionale Amministrazione Software Servizi, S.p.A.; SO.FI.HA., S.r.l.; Sonotec Diffusion, S.A.; Centro de Informatica Educativa S.A.; Ensambladora Tlaxcalteca S.A. (ETSA); Armadoro de Tepeaca S.A. (ATSA); SOMCO Suisse Machinery Co. (Pty) Ltd.; Buromaschinen AG; Oli-Credit S.A.; CIB S.A.; TOMCO (Terminaux et Ordinateurs Multiconcepts) S.A.; Dataid Reseaux S.A.; Data Process, S.a.r.l.

(2)

No. 87-303

Supreme Court, U.S.
FILED
SEP. 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

In The
Supreme Court of the United States
October Term, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DE BENEDETTI, EMMETT R. DeMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

Petitioners,

v.

HANNAH FINKEL,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Is a plaintiff class of investors which purchases securities in an established market at a price artificially inflated by a scheme to defraud or course of business that operates as a fraud on investors, entitled to a presumption of reliance in order to recover for securities fraud under Section 10(b) of the 1934 Act and Rule 10b-5(1) and (3) thereunder?

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No. 87-303

In The
Supreme Court of the United States
October Term, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DE BENEDETTI, EMMETT R. DeMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

Petitioners,

v.

HANNAH FINKEL,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Respondent Hannah Finkel respectfully requests that the Court deny the Petition for Certiorari to the United States Court of Appeals for the Fifth Circuit ("Petition") submitted by Docutel/Olivetti Corporation ("Docutel") and several individuals (collectively the "Defendants") to review a final judgment of the United States Court of

Appeals for the Fifth Circuit. The judgment appealed from (i) reversed the District Court's Order granting Defendants/Petitioners' Motion to Dismiss dismissing Plaintiff's claims under 10b-5(1) and (3) of the Securities and Exchange Commission, and (ii) affirmed the District Court's Order granting Defendants' Motion to Dismiss Plaintiff's claims under Rule 10b-5(2) of the Securities and Exchange Commission.

STATEMENT OF THE CASE

Course of Proceedings and Disposition Below

Plaintiff's complaint arises under Sections 10(b) and 20 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78(a), *et seq.* (the "Exchange Act") and Securities and Exchange Rule 10b-5 promulgated thereunder. Plaintiff brought this action as a class action pursuant to Rules 23 (a) and (b)(3) F.R.C.P.

Defendants filed a Motion to Dismiss. The Motion to Dismiss alleged that the Complaint is fatally defective for failure to allege individual reliance upon misrepresentations of Defendants.

Discovery and class certification were deferred pursuant to agreed orders pending a ruling by the District Court on Defendants' Motion to Dismiss.

On August 20, 1986, the District Court dismissed the Plaintiff's Complaint without prejudice based upon an interpretation of *Shores vs. Sklar,* 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied,* 459 U.S. 1102 (1983), to the

effect that a plaintiff in the Fifth Circuit who purchases securities in an established market cannot rely upon the integrity of the market pursuant to the fraud on the market doctrine, but must plead and prove individual reliance upon specific misrepresentations.

On May 27, 1986, the Fifth Circuit reversed and remanded, holding that to the extent that Plaintiff's Complaint alleged a scheme to defraud or course of business operating as a fraud, Plaintiff had properly pled causes of action under 10b-5(1) and (3). Plaintiff did not have to plead specific reliance upon alleged misrepresentations. The Fifth Circuit affirmed the District Court's dismissal of Plaintiff's Complaint with respect to claims under 10b-5(2), holding that under *Shores,* any fraud on the market claim under section (2) is barred by Plaintiff's failure to allege that she read and relied on any of the documents now claimed to have misrepresented the financial condition of Docutel.

On August 29, 1987, the District Court stayed this action pending this Court's ruling on Petitioner's petition for a writ of certiorari.

STATEMENT OF FACTS

Defendant Docutel/Olivetti Corporation ("Docutel") is a Delaware corporation with executive offices in Irving, Texas. On October 1, 1983, Docutel had issued and outstanding 6,800,000 shares of common stock owned by more than 3,200 shareholders. Docutel's shares were traded in

the over-the-counter market. Defendant Ing. C. Olivetti and C., S.p.A. ("Olivetti") is an Italian corporation with its executive offices located in Italy. Olivetti acquired practical control of Docutel by means of a merger between a subsidiary of Olivetti and Docutel, and the issuance of a warrant by Docutel to the Olivetti subsidiary. Defendants B. J. Meredith and Emmett R. DeMoss were, respectively, the chief executive officer and executive vice president and chief financial officer of Docutel.

Defendants Carlo DeBenedetti and Simone Fubini were respectively the chief executive officer and chief operating officer of Olivetti. Defendant Elserino M. Piol was a reprcsentative of Olivetti who acted as a director of Docutel.

On December 5, 1983, Plaintiff purchased 300 shares of Docutel on the public market at $14-5/8 per share, for a total price of $4,474.75.

Plaintiff alleged that the quarterly earnings of Docutel reported through 1983 were substantially overstated, and losses were understated, by reason of the failure of Docutel, and Olivetti as its controlling shareholder, and the respective officers, to charge off worthless inventories acquired from Olivetti and its subsidiary. Docutel was made to buy inventory from Olivetti which was unsalable, giving rise to the write-downs complained of by Plaintiff in this action.

Plaintiff relied upon the integrity of the public market for Docutel shares in making her purchases and thereby incurred losses by paying the artificially inflated public market prices resulting from the fraudulently overstated earnings.

On February 16, 1984, Docutel announced a projected net loss for the year ended December 31, 1983, in the amount of $14,000,000. On April 2, 1984, the *Wall Street Journal* reported that Docutel said its previously projected net loss for 1983 of $14,000,000 would be significantly wider. In its 10-K for 1983 Docutel reported an after tax loss of $18,263,000 for 1983. The loss included $10,900,000 of inventory write-downs, approximately $10,100,000 of which was recorded in the fourth quarter. Significantly, Docutel made the following admission in its 1983 Form 10-K:

> In 1983, the Company's record keeping procedures and accounting staff were strained due to the significant growth in transaction volume resulting from the merger with Olivetti Corporation, attrition of personnel, and the transfer in the second half of 1983 of OPD accounting function from Tarrytown, New York, to the Company's headquarters in Irving, Texas.

Docutel's stock plummeted from a high of $38-7/8 in 1983 to a closing bid price on April 6, 1984 of $7-1/4, causing public investors to take large losses.

———o———

REASONS FOR DENYING THE PETITION

I. RESPONDENTS WERE ENTITLED TO A REBUTTABLE PRESUMPTION OF RELIANCE UNDER THE FRAUD ON THE MARKET THEORY

The Fifth Circuit Court of Appeals in this case correctly held that since Respondent had alleged a scheme to defraud or course of business operating as a fraud in viola-

tion of Rule 10b-5(1) and (3), Respondent was entitled to a rebuttable presumption of reliance upon proof of materiality of the alleged conduct.

Reliance is generally a requirement to a claim stated under Rule 10b-5. Proof of reliance establishes that the damaged party was induced to act by the defendant's conduct; it defines the causal link between defendant's misconduct and the plaintiff's decision to buy or sell securities. *Dupuy v. Dupuy*, 551 F.2d 1005, at 1016 (5th Cir. 1977), *cert. denied*, 434 U.S. 911 (1977); *Finkel v. Docutel/Olivetti*, 817 F.2d 356 at 359 (5th Cir. 1987). The fraud on the market doctrine, adopted by every Circuit Court of Appeals to consider it[1] permits a plaintiff to rely upon the integrity of an established market to set a price untainted by fraud, without pleading individual reliance upon specific misrepresentations. Most courts have held that a plaintiff is entitled only to a presumption of reliance, which may be rebutted by defendants. In this case, the Court of Appeals held that Defendants may rebut the presumption of reliance in two ways: 1) by showing that the nondisclosures did not affect the market price for the

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[1]See *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986); *Levinson v. Basic*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (Feb. 23, 1987); *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir. 1986), *cert. denied*, No. 85-2036 (Oct. 6, 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot after cert. granted*, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

security; or 2) that plaintiff would have purchased the stock at the same price even if she had known the information that was not disclosed. *Docutel*, 817 F.2d at 364-365.

The fraud on the market doctrine is premised upon the theory that the market price for a security, in an open and developed market, accurately reflects the value of that security if all relevant information has been disclosed in the marketplace.[2] When one fails to disclose or misrepresents material information about a security, the market's efficient pricing mechanism is skewed and the price of the security is distorted. *Docutel*, 817 F.2d at 360. The fraud on the market doctrine recognizes the fact that most investors do not carefully examine all available information about a security because there is too much, and much of it is too technical.[3] Instead the typical investor relies upon the in-

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[2]This is a conclusion of the efficient market theory. The theory states that the market price reflects all representations concerning the stock. The market price of securities is a function of the information the market possesses, both positive and negative, assuming all information is disclosed. *In re LTV Securities Litigation*, 88 F.R.D. 134, 144 (N.D.Texas 1980). *See LTV* for citations to the economic theories and leading works which support the doctrine. *See also*, Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.L 1 (1982); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J.Fin. 383 (1970); Note, *Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143 (1982); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031 (1977).

[3]*See*, Fischel, 38 Bus. Law, 1, 2-5; *Docutel*, 817 F.2d at 360 n. 9 ("[R]ecent scholarship suggests that the dissenters' vision of individual investors reading and relying upon information required to be disclosed in registration statements and the like is suspect. Most SEC disclosure documents not only go unread by their intended recipients but in fact 'can only be used effectively by market professionals.' ") (quoting Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143, 1159 (1982) and H. Kripke, *The SEC and Corporate Disclosure* at 14 (1979)).

tegrity of the market to be free from deception and to value accurately a security in light of all the material information about the security. The market becomes the theoretical agent of the investor. Consequently, a purchaser or seller who relies on the market to value the security accurately suffers damages if the market does not have all the information or if some of the information is false.

The ability of an investor to rely upon the market price for securities as reflecting an individual issuer's prospects is critical to liquidity in the nation's capital markets. Most investors rely upon the integrity of the public market when they invest. The typical investor has insufficient time to review all of the data available with respect to individual securities considered for purchase. Thus, there are important economic bases, as well as legal bases, for the fraud on the market doctrine. It is for these reasons that the fraud on the market doctrine has been adopted in every circuit to consider it. *See* note 1 above.

II. THE FRAUD ON THE MARKET DOCTRINE FURTHERS THE CLEAR INTENT OF CONGRESS.

Petitioners wrongly contend that in adopting Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), Congress intended to incorporate the basic elements of common law fraud. Petitioners mischaracterize Congress' intent in an attempt to overturn the fraud on the market doctrine against the great weight of judicial, scholastic and administrative authority that supports it.[4] The

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[4]See *supra* note 1 and accompanying text; *Docutel*, 817 F.2d at 361 ("The Securities and Exchange Commission accepts the efficient market hypothesis, which underlies the fraud on the

(Continued on next page)

creation of the many new rules contained in the '33 and '34 Acts constitutes Congressional recognition of the inability of state common law principles to deal with securities fraud. Nowhere in the text of Section 10(b), or Rule 10b-5 promulgated thereunder, are the alleged elements of common law fraud required.[5] Section 10(b) was deliberately couched in broad terms and intended to be a catch-all to prevent manipulative devices that theretofore ran rampant.[6]

(Continued from previous page)

market theory.") (footnote omitted); *see also* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L.Rev. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash.& Lee L.Rev. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627 (1982); Note, *Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982).

[5]At the outset, Petitioners cite *Kardon v. National Gypsum*, 69 F.Supp. 512 (E.D.Penn. 1946) for the proposition that the cause of action under Rule 10b-5 has always incorporated the basic elements of the common law deceit action. This is simply not correct. In *National Gypsum* the plaintiffs made claims based upon both common law fraud and Rule 10b-5. The court held that plaintiff's allegations sustained both claims. Nowhere did the court require the allegations of a common law fraud claim as a prerequisite to a claim under Rule 10b-5. The court simply held that the allegations as they were made sufficed to uphold claims under both 10b-5 and common law fraud.

[6]In summing up Section 9(c) before the House Committee, which without significant alteration became Section 10(b) of the Act, one of the principal drafters said the following:

> "Subsection (c) says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection . . . (c) is a catch-all clause to prevent manipulative devices[.] I do not think there is any objection to that kind of a clause. The Commission should have authority to deal with new manipulative devices."

(Continued on next page)

The fraud on the market theory actually embraces Congress' intent. The fraud on the market theory adheres to legislative intent by fostering public confidence in the markets, by deterring fraud and by promoting judical efficiency through the class action vehicle.

Restoring investor confidence in the securities markets was a primary reason for adopting the federal securities laws. *See* 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud*, Section 2.2(110) at 2:13 (1986) ("[Statutory antifraud provisions] were part of the initial New Deal response to the financial debacle of the 1920's, investigations of which revealed widespread fraud, manipulation and victimization of public investors by concealment of relevant information"). With respect to Section 10 and Rule 10b-5, courts have held that "[t]he statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely." *Blackie v. Barrack*, 524 F.2d at 907; *see also, Lipton v. Documation*, 734 F.2d at 748. The ability of an investor to rely upon the honesty and integrity of the market is critical to liquidity in the nation's capital markets. As one court has noted, "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would know-

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(Continued from previous page)

Testimony of Thomas G. Corcoran, Hearing on HR 7852 and HR 8720 before the House Committee on Interstate and Foreign Commerce, 73d Congress, 2d Sess., 115 (1934). The courts have quoted this comment in giving broad interpretation to Section 10(b). *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 766 (1975) (dissent of Blackmun J.); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969).

ingly roll the dice in a crooked crap game?'' *Schlanger v. Four-Phase Systems, Inc.*, 555 F.Supp. 535, 538 (S.D. N.Y. 1982).

The fraud on the market doctrine recognizes the fact that the legislative policy designed to foster investor expectations of honesty in the securities markets has become reality. Investors rely upon the integrity of the market when they invest. They purchase upon the assumption that the market price is free from any unsuspected manipulation that could inflate the market price. The fraud on the market doctrine simply furthers the goals of the securities laws by protecting those that rely on the integrity of the market when they invest. *Blackie v. Barrack*, 524 F.2d at 907. Such investors may recover from corporate wrongdoers without proving individual reliance on specific misrepresentations, but by showing that they relied upon the integrity of the market when they purchased the security —an expectation on which purchasers should be able to rely. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect or on the integrity of the public market place. The securities laws would operate to protect only those investors with enough time and sophistication to digest all information disseminated into the public market, despite the fact that all investors who rely on the honesty of the market suffer the damage of purchasing a security at a price inflated by material misrepresentations. To leave such open market purchasers unprotected is not consistent with the policies under the federal securities laws. Investors should and do rely upon the integrity of the public market when they invest.

To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered. Brief for the Securities and Exchange Commission as Amicus Curiae at 26, *Basic v. Levinson,* No. 86-279 (U.S. filed April 1987). There is no doubt that implied private actions under 10b-5 effectively enforce the securities laws. *Id.* (The Securities and Exchange Commission noted that the Supreme Court has "repeatedly . . . emphasized . . . that implied private actions [under Rule 10b-5] provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" (quoting *Bateman Eichler, Hill Richards, Inc. v. Berner,* 472 U.S. 299, 310 (1985)).

Federal securities laws were also adopted for the purpose of efficiency in enforcing in one case all claims that arise out of a single transaction. As commentators have written,

> The securities laws create nationwide service of process and have a liberal venue rule that permits litigation to consolidate all defendants and all claims in a single forum. The class action device created by Rule 23 of the Rules of Civil Procedure makes it easy to bring all plaintiffs together.

Easterbrook and Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 Va.L.Rev. 669, at 680 (1984). The fraud on the market doctrine has special and obvious appeal in class actions because the need to prove a personalized reliance by each class member is avoided. The question of reliance usually arises in the context of whether

or not to certify a class.[7] If a plaintiff in a securities fraud action must plead and prove individual reliance, then class certification is probably improper, because issues of individual reliance will predominate. If the class action procedural device can no longer be used to handle major securities cases, then defendants will gain some measure of relief because not all defrauded investors will sue.–As one commentator pointed out:

> The only person whose behavior is likely to be changed are would-be defrauders, because the fraud-on-the-market theory, by eliminating issues of individual reliance, facilitates class action recovery of claims that would otherwise be too small to be litigated individually. And here, possibly, lies an unstated rationale for the fraud-on-the-market decisions, almost all of which involved class actions: only if courts allow class actions to proceed will under-inclusive recoveries and hence a failure to deter fraud at its inception be avoided.

(footnote omitted) Note, *Fraud-on-the-Market Theory,* 95 Harv.L.Rev. 1143, at 1159 (1982). Moreover, there will no doubt be many separate suits filed by investors who are in a position to plead and prove individual reliance. The cost to the judicial system in litigating each of such suits separately will likely be unacceptable.

Petitioners argue that the fraud on the market doctrine is inconsistent with the full disclosure policy of the se-

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[7]For example, in *In re LTV Securities Litigation,* 88 F.R.D. 134 (N.D.Tex. 1980), the question of whether to apply the fraud on the market doctrine arose in the context of a motion to certify a class of more than 100,000 members who traded nine (9) different types of securities over a period of three and a half years. *Id.* at 140.

curities laws. Such is not correct. In fact, it is obvious that the fraud on the market doctrine could not exist without the full disclosure contemplated by the securities laws. The doctrine assumes that the markets have assimilated all available information. However, liquidity in the markets requires that investors who have not had an opportunity to read every disclosure made by a company, or who may not be sophisticated enough to understand all the disclosures, may nevertheless invest at the market price upon the assumption that such price represents the consensus price established by interested and informed investors. "Various market professionals still have an incentive to secure information until a marginal dollar invested in processing information equals the profits to be made from trading on superior forecasting."[8]

Petitioners' argument that the fraud on the market doctrine establishes a policy of "investor's insurance" implies that each investor can collect his full damages in the event he loses money as a result of securities fraud. This contention is totally unfounded. Even if individual reliance is presumed until defendants have an opportunity to rebut the presumption, it remains necessary for defrauded investors to prove fraud. What Petitioners seek

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[8]Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.L. 1, at 4 (1982). Professor Fischel explains it, "Markets may be analyzed as having two classes of participants. One class will have a comparative advantage, actors in this class have an incentive to invest in gathering and analyzing information and to take actions to affect the market. The other class, however, lacking a comparative advantage, has no incentive to invest in processing information because it cannot profit thereby. The first group will earn a superior return commensurate with their greater investment skill." *Id.*

is practical immunity from prosecution for corporate wrongdoers. Even if a defrauded investor can prove liability, the plaintiff still recovers only his out-of-pocket damages. The out-of-pocket damage rule established in *Green v. Occidental,* 541 F.2d 1335, 1341 (9th Cir. 1976) (Sneed, J., concurring); *see, e.g., In re LTV Securities Litigation,* 88 F.R.D. 134 (N.D.Tex. 1980), permits an investor to recover only that portion of his total loss which is due to defendants' fraud. While most class actions are indeed settled, the settlements frequently result in a recovery of only pennies on the dollar to defrauded investors. This is scarcely a plan for "investor insurance," but is an effective plan for keeping corporate management as honest as possible.

Petitioners' argument that upholding fraud on the market claims under Rule 10b-5 constitutes the effective repeal of Section 18(a) is similarly unfounded. Petitioners ignore the fact that in this case Plaintiff alleges a scheme to defraud the market by disseminating fraudulent information not only in the SEC filings, but also in publicly disseminated reports appearing in *The Wall Street Journal.* Section 18(a) limits its remedy to fraudulent SEC filings. Furthermore, this Court has already rejected an interpretation of the securities laws that displaces an action under Section 10(b) merely because of the availability of express remedies under other sections. In *Herman & MacLean v. Huddleston,* 459 U.S. 375, 384-387 (1983) this court said, "In savings clauses included in the 1933 and 1934 Acts, Congress rejected the notion that the express remedies of the securities laws would preempt all other rights of action . . . We therefore reject an interpretation of the securities laws that displaces an

action under Section 10(b)." (footnotes omitted). A cumulative construction of the securities laws furthers the broad remedial purposes of the securities laws and furthers Congress' intent in enacting the 1934 Act, "to impose requirements necessary to make [securities] regulation and control reasonably complete and effective." *Id.* (quoting 15 USC Section 78b [15 USCS Section 78b]).

Courts have similarly rejected the notion that there must be additional and differing elements contained in a Section 10(b) claim to justify a civil remedy under 10(b) when other remedies were available under other sections of the Securities Acts. *See, e.g., Chemetron Corp. v. Business Funds, Inc.,* 718 F.2d 725 (5th Cir. 1983). Nonetheless, plaintiffs face a more difficult task in stating a claim under section 10(b) where plaintiff must allege *scienter,* as opposed to stating a claim under Section 18 where an allegation of *scienter* is not a requirement. *Ross v. A.H.Robins Co.,* 607 F.2d 545, 556 (2d Cir. 1979), *cert. denied,* 446 U.S. 949 (1980).

III. THIS COURT HAS PREVIOUSLY CONSIDERED THE INDIVIDUAL RELIANCE ISSUE IN THE SECURITIES FRAUD CONTEXT

Two decisions by this Court, *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970) and *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972), demonstrate this Court's recognition that under certain circumstances, causation in a securities fraud suit is adequately established by proof of materiality, without direct proof of individual reliance.

In *Mills* this court expressly noted the judicial utility in substituting materiality for direct proof of reliance in

large securities fraud cases. In *Mills,* minority shareholders alleged, under Section 14(a) of the Exchange Act, 15 U.S.C. Section 78n(a) (1976), that shareholder approval of a merger had been obtained via a misleading proxy statement. This Court acknowledged that "reliance by thousands of individuals . . . can scarcely be inquired into." *Id.* at 380 (citation omitted). As an alternative, this Court stated,

> There is no need to supplement this [materiality] requirement . . . with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury . . .

Id. at 384-85. The *Mills* case is also informative because this Court found liability without proof of individual reliance, even though *Mills* involved an implied remedy under Section 14(a). Like Section 10(b) of the Exchange Act, the remedy under Section 14(a) is a judicially implied remedy.

In *Affiliated Ute,* a Rule 10b-5 case, this Court dispensed with the need of plaintiffs to establish reliance in nondisclosure cases involving open market transactions. Like the Court of Appeals in this case, this Court noted the distinction between paragraph (2) of rule 10b-5 and paragraphs (1) and (3), saying that the former is restricted to "the making of an untrue statement of a material fact and the omission to state a material fact." *Id.* at 152-153. Nevertheless, this Court continued, the first and third paragraphs are not so restricted, they deal with a course of business or a device, scheme, or artifice that operated as a fraud. *Id.* Thus, this Court held,

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. 153-154. *Affiliated Ute* has been widely interpreted as eliminating plaintiff's need to establish reliance in nondisclosure cases involving open market transactions. *E.g.*, *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978); *Rifkin v. Crow*, 574 F.2d 262-63; *Dorfman v. First Boston Corp.*, 62 F.R.D. 466, 471 (E.D.Pa. 1974).

The decision by the Court of Appeals below hardly conflicts with decisions by this Court. To the contrary, the decision below embraces policies long recognized by this Court that in certain securities fraud suits, materiality oftentimes sufficiently establishes causation in fact. Where through a scheme to defraud or course of business a defendant disseminates misrepresentations that artificially inflate the market price for a security, plaintiffs should be entitled to a presumption of reliance upon proving materiality.

IV. PETITIONERS DO NOT HAVE STANDING TO ASSERT THE CONFLICT WITHIN THE CIRCUITS AS A REASON FOR THIS COURT TO GRANT CERTIORARI.

Article III of the constitution limits the judicial power of the United States to resolution of "cases" and "controversies." As an incident to this requirement, this Court

has always required that a litigant have "standing." To have "standing" a litigant must show that he personally has some actual or threatened injury. *Valley Forge College v. Americans United,* 454 U.S. 464, 471-473, 70 L.Ed. 2d 700, 102 S.Ct. 752 (1982).

On page fifteen of their brief, Petitioners urge this Court to grant certiorari because of an alleged conflict within the Circuits. Petitioners contend that the Fifth Circuit's decision in this case is in conflict with decisions in other Circuits. In this case the Fifth Circuit held that a plaintiff is permitted to assert a fraud on the market theory under 10b-5(1) and (3), but not under 10b-5(2). In 10b-5(2) cases, plaintiffs must still prove individual reliance upon specific misrepresentations. In their opinion, the Fifth Circuit recognized that other Circuits permit the fraud on the market theory under 10b-5(2).[9] Nevertheless, the Court declined to so hold and for this reason upheld the District Court's dismissal of Respondent's claim stated under 10b-5(2). The Fifth Circuit's decision thus favored Petitioners. Due to the conflict, Petitioners need only defend themselves against claims stated under 10b-5(1) and (3). Consequently, Petitioners cannot urge the conflict among Circuits as a basis for this Court to grant certiorari. Petitioners have suffered no injury. They have actually benefited from the conflict among Circuits.

It is Respondent who has suffered injury by virtue of the conflict among Circuit Courts. If Respondent could

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[9]*See, e.g., Peil v. Speiser,* 806 F.2d 1162-63; *Lipton v. Documation,* 734 F.2d 740; *Blackie v. Barrack,* 524 F.2d 891.

have brought this action in the Third or Eleventh Circuits, her claim under 10b-5(2) would not have been dismissed. Such is not the case, however, and Respondent has suffered an injury in the dismissal of part of her case. Notwithstanding the conflict among Circuit Courts, the injury is peculiar to Respondent, and Respondent alone may urge the conflict among the Circuits.

V. THIS CASE DIFFERS FROM BASIC V. LEVINSON WHICH IS CURRENTLY BEFORE THIS COURT.

On page 19 of their brief Petitioners argue that this Court should consider this case as a companion to *Levinson v. Basic,* 786 F.2d 741 (6th Cir. 1986), *cert. granted,* 107 S.Ct. 1284 (Feb. 23, 1987) (No. 86-279). These cases differ, however, and should not be considered as companion cases. First, as admitted by Petitioners, *Basic, Inc.* raises the issue in the context of class certification under Fed.R.Civ.P. 23(b)(3). The standard of review is abuse of discretion. In this case, the issues arise under a Fed.R.Civ.P. 12(b)(6) motion to dismiss, presenting a pure question of law. Thus, these cases are to be reviewed under differing standards.

Second, *Basic, Inc.* does not distinguish between causes of action stated under 10b-5(1) and (3), and causes of action stated under 10b-5(2). *Basic, Inc.* considers material misrepresentations in public statements relating to the existence of merger negotiations. There is no issue as to a scheme to defraud or course of business that operated as a fraud. *Basic, Inc.* is primarily a 10b-5(2) case. This case on the other hand hinges on a scheme to defraud or

course of business to defraud in violation of Rule 10b-5(1) and (3).

Further, *Basic, Inc.* presents questions of whether *sellers* may utilize the fraud on the market doctrine as well as *purchasers*. This issue is not presented on this appeal.

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CONCLUSION

For the foregoing reasons, the Petition For A Writ Of Certiorari to review the decision of the United States Court of Appeals for the Fifth Circuit should be denied.

Respectfully submitted,

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September 1987.

No. 87-303

Supreme Court, U.S.
FILED
OCT 1 1987
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH AND ELSERINO M. PIOL,

Petitioners,

—v.—

HANNAH FINKEL,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF

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DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH AND ELSERINO M. PIOL,

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—v.—

HANNAH FINKEL,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF

I. FRAUD ON THE MARKET THEORY DOES NOT "PRESUME" RELIANCE; IT ELIMINATES IT

Respondent's brief in opposition emphasizes petitioners' main point: "fraud on the market theory" does not "presume" reliance, it eliminates it as an element of the Rule 10b-5 cause of action.[1] Respondent states that "[t]he fraud on the market doctrine . . . permits a plaintiff to rely upon the integrity of the market . . . without pleading individual reliance upon specific misrepresentations." Respondent's Brief in Opposition ("Respondent's Brief"), p. 6. In other words, the fraud on the

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1 For the list of the corporate petitioners' parents, subsidiaries and affiliates required by Supreme Court Rule 28.1, see pages 33a-35a of the Appendix to the Petition for Certiorari filed in this Court on August 21, 1987 (the "Petition").

market plaintiff need not prove that he or she was induced to act by the defendant's conduct.

Significantly, the fraud-on-the-market-theory defendant's right to "rebut" the so-called "presumption of reliance" has nothing to do with proving that the plaintiff was *not* induced to act by the defendant's conduct. The only way for the defendant to rebut this "presumed reliance" is to show either (1) that the alleged fraud did not affect the security's market price (in which event there is no cause of action, as there are no damages), or (2) that even if the plaintiff had known of the fraud, he or she would have been willing to pay an inflated price for the security. *See, e.g., Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 357, 364-65 (5th Cir. 1987).

A defendant thus cannot rebut "reliance" by showing that the misleading information had no effect on the plaintiff's decision to buy, because what induced her decision to buy is irrelevant. Indeed, Mrs. Finkel would have bought Docutel stock no matter what the stated values of the inventories were, since she ignored all information about the company, including its inventory values and earnings. She knew nothing at all about the stock, except the price at which she bought it.[2] The only way to rebut Mrs. Finkel's "reliance" would be for her to state: "I would have bought knowing that the price was fraudulently inflated." Not only will this never happen, it also

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2 Fraud on the market theory radically alters the materiality requirement as well as the reliance requirement. Since, under the theory, the "reasonable investor" need not know anything about a stock, it is impossible to determine whether any information about a stock would be material to this investor. The only person whose judgment matters is the hypothetical "market professional" who, it is assumed, actually relies on information about a company. *See* Pickholz and Horahan, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 Wash. & Lee L. Rev. 943, 960-61 (1982) (logic of fraud on the market theory dictates replacing the "reasonable investor" standard of materiality with a "professional investor" standard). Thus, under the guise of increasing individual investor confidence in the market, the fraud on the market theory makes the individual investor irrelevant. There is nothing in the history of the securities laws to suggest that Congress intended such a result.

does not logically test whether Mrs. Finkel's decision to invest was *induced* by the petitioners' alleged misrepresentations.

There is absolutely no connection between petitioners' alleged conduct and respondent's reasons for buying Docutel stock. If respondent has nevertheless stated a claim for relief under Section 10(b) and Rule 10b-5, then the reliance requirement is dead.

II. FRAUD ON THE MARKET THEORY IS INCONSISTENT WITH CONGRESSIONAL INTENT IN CREATING SECTION 10(b)

Recognizing that fraud on the market theory means the end of reliance, respondent argues that reliance is an anachronism. She states that its elimination actually furthers congressional intent in the securities laws. Respondent's Brief, pp. 9-16. In fact, the elimination of reliance runs directly counter to congressional intent. Congress established a careful balance in the securities laws. *See* Petition, pp. 11-12. Congress expressly required a plaintiff to prove both individual reliance on the alleged fraud as well as the fraud's impact on a security's market price under Section 18(a)—the closest analogue to the implied action under Section 10(b).[3] *See* Black *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 465 (1984).

Respondent also ignores Section 10(b)'s explicit reference to "deception," which traditionally requires proof of reliance. She focuses instead on the Section's prohibition of "manipulation." This Court has held that manipulation is virtually a term of art in the securities field, generally referring to practices such as "wash sales," "matched orders" or "rigged prices." *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

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3 The similarities between Section 18(a) and Section 10(b) provide significant insight into the proper contours of the implied Section 10(b) action. Two sections of a statute adopted at the same time should be construed as part of a unified whole.

This is not a manipulation case. It is a deception case, as are almost all fraud on the market cases. This case involves nothing but alleged misstatements of Docutel's inventory and earnings. *See* Petition, pp. 16-18; *see also* Respondent's Brief, pp. 15, 18 (complaint alleges that defendants disseminated "fraudulent information" and "misrepresentations"). Deceit, like manipulation, had commonly accepted elements that Congress undoubtedly knew. Reliance was one of those elements. Courts should not be permitted to use fraud on the market theory to remove that reliance requirement from Section 10(b).

Finally, respondent argues that maintaining the reliance requirement will frustrate recoveries except for sophisticated investors ~~who can~~ digest every disclosure made by a company, and that it will mean the end of securities class actions. Respondent's Brief, pp. 11-14. She is mistaken.

First, 10b-5's reliance requirement does not mean that every investor must read all publicly available information about a company. It simply means that the allegedly fraudulent information that is the basis of the lawsuit must have affected the plaintiff's investment decision.[4] This requirement can be easily met. Even the most complicated financial statement boils down to a company's earnings. Respondent could easily have satisfied the reliance requirement if her decision to purchase had been based on Docutel's allegedly inflated earnings. All she had to do was read the business section of one of the many newspapers that report companies' earnings on a regular basis. Yet she cannot make even this most minimal showing; she did not bother to do *any* examination of Docutel's financial performance. Permitting such a wilfully ignorant plaintiff to

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4 Interestingly, the facts of the case that respondent holds up as the Second Circuit's adoption of fraud on the market theory, *Panzier v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot*, 459 U.S. 1102 (1982), support the view that the plaintiff had satisfied the traditional reliance requirement. The plaintiff had relied on a Wall Street Journal article and the advice of her broker, both of which were allegedly tainted by the fraud, in making her investment decision. Thus reliance or "transaction casusation" was present. *See* 663 F.2d at 367; *see also* Note, *The Fraud-On-The-Market Theory*, 95 Harv. L. Rev. 1143, 1151 n.34 (1982).

recover exemplifies how fraud on the market theory has turned Rule 10b-5 into a scheme of "investors' insurance."

Second, respondent's concern about the demise of Rule 10b-5 class actions is misplaced. The district court may still certify classes as to common issues of materiality, scienter, and market impact. Individual issues such as proving a purchase or sale and damages will always exist. It is no more inefficient or costly to the judicial system for plaintiffs to demonstrate individual reliance at the same time. The reliance requirement will of course deny recovery to those who cannot establish reliance, but this is true of any limitation on a cause of action short of absolute liability. Congress clearly intended to limit the class of plaintiffs who could sue under the securities laws. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975).[5] The reliance requirement, like the purchaser/seller requirement and the scienter requirement, reflects the balance Congress intended to strike between the rights of securities law plaintiffs and defendants.

III. THE SUPREME COURT CASES ON RELIANCE CITED BY RESPONDENT ARE INAPPOSITE TO THIS CASE

Respondent cites *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) as examples of this Court's recognition that, under certain circumstances, causation in a securities fraud suit may be established by proof of materiality, without direct proof of individual reliance. Respondent's Brief, pp. 16-18. What respondent fails to perceive is that those "circumstances" are inapposite to this case.

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5 The fact that the Securities and Exchange Commission has incorporated the "efficient markets hypothesis" ("EMH") into its disclosure rules, does not mean that the EMH and fraud on the market theory should be applied to change the elements of a private cause of action under Rule 10b-5. The reliance element reflects a congressional determination on the proper scope of liability. *See* Petition at p. 12.

Mills and *Affiliated Ute* are both pure "omissions" cases. This Court held that in such cases the difficulty of proving reliance on a non-event should not preclude a plaintiff from recovery. *See Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 50-51 (1977) (Blackmun, J., concurring) (discussing the *Mills-Affiliated Ute Citizens* presumption of reliance). *See also* Fischel, *Use of Modern Finance Theory In Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 7-8 (1982) ("It is this difficulty of proof, rather than any conceptual difficulty with the [reliance] requirement itself, that eliminates the need for proof of reliance in omissions cases.").

Mills and *Affiliated Ute* thus provide no support for eliminating the reliance requirement where there is no logical difficulty in proving reliance. Here, the complaint is based entirely on alleged misstatements of Docutel's inventory and earnings in SEC filings and the Wall Street Journal. *See* Respondent's Brief, p. 15. Respondent faces no logical difficulty in proving reliance; under *Mills* and *Affiliated Ute*, she should be required to do so.

IV. THE DIFFERENCES BETWEEN *BASIC INC.* AND THE PRESENT CASE UNDERSCORE THE DESIRABILITY OF ALSO GRANTING THE PETITION IN THIS CASE

Respondent argues that the present case differs from *Basic Inc. v. Levinson*, No. 86-279, now scheduled for oral argument before this Court on November 2, 1987, and that therefore this case should not be heard as a companion to *Basic Inc.*, Respondent's Brief, pp. 20-21. Petitioners have argued, however, that it is *because* the cases are different that this Court should also grant their petition. For the reasons enumerated in the petition and reiterated in respondent's brief in opposition, this case represents a superior vehicle for resolving the controversy over the fraud on the market theory. If scheduling problems make it impossible to hear this case along with *Basic Inc.*, this Court should hear this case on its own timetable. Only in this case is this Court presented with a pure question of

law: is reliance an essential element of a claim for relief under Section 10(b) of the 1934 Act and SEC Rule 10b-5?

CONCLUSION

For all of the foregoing reasons, the writ should issue.

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October 1, 1987

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